Tax management strategies for Alberta farmers

After tax reform

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Tax Management Strategies for Canadian Farmers

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Alberta
AGRICULTURE
Farm Business Management Branch

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Preface

Taxation is one of the major factors that influence the decisions made by the farm manager in the operation of a farm business. The implications of various tax strategies should be considered as the manager looks at the profitability, costs, investment patterns, production and projected cash flows in guiding his farm business toward economic and personal goals.

With tax reform in 1972 and 1988, we have seen many changes in the tax laws pertaining to agriculture. The result has been an increased need for an information source which the farmer can use to assist him in understanding the various tax management strategies or tools available.

This publication discusses the various tax strategy alternatives available for farmers. With a basic understanding of the tax rules in relation to the farm business, the farm manager is better able to ask the right questions when considering an alternative. The material presented here SHOULD NOT BE CONSIDERED AS AN INTERPRETATION OR A REPLACEMENT FOR THE LEGISLATION, as changes in our tax laws are continually being made. Specific problems with respect to tax management decisions should be referred to an accountant, lawyer, or tax advisor who is aware of current changes which may have occurred since the preparation of this publication. The final decisions should be based on the exact wording of the law.

Throughout the text, the use of italic print signifies rules that only come into force for the 1989 or subsequent taxation years.

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Introduction

This publication discusses what are felt to be the most important and significant tax strategies available to farmers as an important tool in managing the farm business.

For many people, tax management often means the necessity of filing their income tax returns each year. Along with this, a popular goal is to get the final line on the tax form to zero. The important thing to keep in mind, as far as tax management is concerned, is that the objective should be to **maximize income after tax**, not just to minimize the tax obligation.

From both a business and personal point of view, the more dollars you make, the further ahead you are. As long as you take home part of the last dollar of income, it is worth earning that dollar.

To illustrate this objective in tax management, consider the case of two neighbours, each with a dependent spouse and two children under age 18. The individuals have incomes of $50,000 and $20,000 respectively in 1988. The farmer with income of $50,000 paid approximately $18,000 in taxes, leaving him with $32,000. The other farmer with income of $20,000 paid approximately $3,000 in taxes, leaving him with $17,000. The farmer with the income of $20,000 that year said to his neighbour, "Well, I'm sure not going to fall into the trap of paying all the tax that you had to pay." If we stop and look at each farmer's position, who is really better off? The neighbour who added $32,000 to his bank account or the neighbour who added $17,000 to his bank account?

By looking at the after-tax financial effects of production, marketing and tax planning alternatives, you can direct the farm business towards achieving both personal and business goals.

Tax planning is generally concerned with making a choice of one or more legitimate alternatives which leads to creating the least amount of tax. Tax planning falls into one of the following classes:

- Deferral of Tax
- Saving of Tax

The deferral of tax is concerned with the timing of the payment of any tax liability and may not necessarily reduce the overall taxes paid. Such strategies as registered retirement savings plans and rollovers serve primarily to defer taxes. Generally speaking, the practice of deferring taxes does not usually upset tax officials because eventually Revenue Canada will collect the tax revenue otherwise due. A deferral of tax may, given consistent levels of inflation, lead to real savings if the future tax liability is to be paid using dollars which are not worth as much as today's dollars.

The saving of tax, on the other hand, serves to reduce the overall amount of taxes actually paid. Splitting income between husband and wife or using various business arrangements can serve in reducing the total tax bill. In comparison with tax deferral, tax savings will usually attract closer scrutiny by the tax officials.

Tax planning should be a year-round activity, and must always be balanced with good sound business judgment as well as personal considerations. Effective tax planning requires:

- personal financial goals;
- up-to-date records and financial information;
- reliable long range projection of size and source of income.

Other factors to consider include the relevant tax laws, bank interest rates, and inflation rates. The prime objective in tax planning should be to ensure that taxable income from any transaction either occurs or can be reported in the year it will be most lightly taxed.

When planning your affairs, it is important to keep in mind that what is advantageous for someone else may not necessarily be good in your situation. Keeping good records can tell you what your specific situation is and can be used to

reveal which tax alternatives are best for guiding your farm business towards economic and personal goals.

This publication discusses the various tax strategy alternatives available for farmers. By having a basic understanding of the tax rules in relation to the farm business, you should be able to ask the right questions when considering alternatives. Should additional assistance be required, you should contact your tax advisor who is up-to-date with the tax laws.

The Income Tax System

Regular Tax

The federal tax system in Canada, for individuals, is based on a progressive rate structure. This means that the higher an individual's taxable income, the higher the rate of tax on the last dollar of taxable income. To illustrate this concept, consider again the case of the two neighbours, one with an income of $50,000 and the other with $20,000. The last dollar earned by the farmer with the $50,000 income was subjected to federal tax at the rate of 26% whereas the last dollar earned by the other farmer was taxed at a federal rate of 17%. (Since the provincial tax is calculated as a percentage of the federal tax before the surtax, the individual's original tax rate in Alberta is an additional 46.5% of the federal rate.) The appendix contains a chart of the federal marginal tax rates as well as the tax rates for each of the provinces for 1988.

Given the progressive rate structure of the income tax system the total tax paid by two individuals "sharing" a given level of taxable income will be less than the tax paid by one individual on the same level of taxable income. This is the basic premise behind the technique known as income splitting. The idea is to split income which would be taxed at a high marginal rate to a **spouse or child**, where it would be taxed at a lower marginal rate. This technique was made easier by the repeal, effective after 1979, of certain provisions which prevented an individual from claiming, as a business expense, remuneration paid to a spouse who was an employee. It is now possible for a farmer to pay a spouse a salary where the spouse is involved in the operation of the farm. Paying a child a salary also has tax benefits for the family.

Revenue Canada's position on remuneration to a spouse or a child is that the following conditions must be present before such remuneration will be deductible:

- the salary or wages must actually be paid to the spouse or child;
- the amount of remuneration must be **reasonable in light of the services provided** by the individual in the operation of the business;
- the services were for the production of income;
- it would have been necessary to obtain outside help to perform the tasks carried out by the individual.

Minimum Personal Income Tax

In addition to the regular tax system as outlined above, an Alternative Minimum Tax (AMT) was introduced in 1986. This was a response to a concern that a number of high-income individuals were paying little or no income tax.

The AMT applies to individuals and trusts only. These taxpayers must calculate their AMT provided that a number of criteria are met, some of which are:

1. Taxable dividends exceeding $50,000 are reported;
2. Investment tax credits are claimed;
3. A taxable capital gain in excess of $40,000 is reported.

These rules are not intended to be all-inclusive and are also very general in nature.

If any of these rules apply, form T691 will determine if the AMT is payable. It would only be payable if regular federal tax is less than the AMT calculated on form T691.

How Is AMT Calculated?

In computing AMT, the first step is to start with taxable income for regular tax purposes and then revise a number of deductions. For instance, RRSP contributions are not allowed as a deduction in determining the AMT. As well the portion of a capital gain that is normally not taxable (i.e., 1/3 of the capital gain) must be added to taxable income. (An exception to the last rule is in regards to capital gains that arise as a result of property foreclosures).

For AMT purposes, a $40,000 exemption is applied to reduce taxable income subject to the AMT. When these revisions are made a flat 17% tax rate is applied to the revised amount. If the resultant tax exceeds regular federal tax then the greater of the two amounts is the tax to be reported as payable.

To the extent that AMT exceeds regular federal tax in a year, this excess can be carried forward for seven years to reduce regular federal tax payable in excess of AMT in those future years.

Special Considerations

A common mistake tax filers make is reducing regular federal tax below the AMT by utilizing investment tax credits. In these cases AMT is payable, but the opportunity to carry forward the excess Investment Tax credit claimed against regular federal tax is effectively lost.

A general rule of thumb in this case is to reduce regular federal taxes by investment tax credits only to the point at which this reduced amount equals AMT. The unused investment tax credits can then be carried forward to reduce tax payable in future years.

An exception to AMT occurs in a year that a farmer block averages. For example, if a farmer incurs a large capital gain, that may subject him to the AMT it may be worthwhile to block average in order to avoid AMT.

Another matter relating to block averaging is that any minimum tax assessed in prior years, and any credit claimed in a year for minimum tax paid in prior years, will not be taken into account for block averaging purposes. The purpose of this recent change to the Income Tax Act is to simplify the block averaging computations.

Farming – As the Tax Man Sees It

When is a farm a farm? As unusual as this question may seem, it is a matter that must be resolved to ensure that our federal and provincial tax laws do not operate in an unforeseen manner. The response to this question is of great importance where, for example, the owner of a farm dies or transfers property to a child by way of a gift. At that time, persons who have been in the business of farming and own a family farm may be entitled to receive beneficial income tax treatment. It could mean the difference between being forced to dispose of the farm assets to satisfy an income tax obligation or having the transition of farm ownership proceed without the incidence of income tax at the time of the transfer. The amount of taxes payable will depend on whether or not the facts in each case fit the definition of "farming" as outlined in the law.

Although the Income Tax Act does not specifically define farming, it does include the following activities under the definition of farming:

- tillage of the soil;
- livestock raising or exhibiting;
- maintaining of horses for racing;
- raising of poultry;
- fur farming;
- dairy farming;
- fruit growing;
- keeping of bees.

In addition to these activities which are specifically mentioned in the law, the following operations would, normally, also qualify:

- raising Christmas trees;
- nurseries and greenhouses;
- running a wild game reserve;
- raising race horses for resale;
- certain feedlot operations;
- operating a chick hatchery; and
- market gardening.

There are undoubtedly other farming activities which could qualify.

The following types of operations, although they may involve the feeding of livestock, are not considered to be farming operations:

- acting as an agent or broker for the sale of livestock;
- buying livestock for resale as quickly as a favorable opportunity presents itself, where this activity is conducted as the main business of the operation;
- assembling livestock (where the animals are held for less than three months).

Farming does not include trapping, or employment under another person engaged in the business of farming.

Methods of Reporting Income

All businesses in Canada are required to report their income for tax purposes on an annual basis. Farmers and ranchers are fortunate in that they can determine their income using either the cash or accrual methods. Although most other businesses are required to file on the accrual basis, the majority of farmers file on the cash basis because of the flexibility and tax deferral opportunities it offers. The issue of cash versus accrual reporting methods should not be confused with the Mandatory Inventory Adjustment discussed on pages 54 to 57.

Accrual Method

Under this method, income is reported in the year it is earned, regardless of when payment is received, and expenses are deductible in the year in which they are incurred, whether paid or not. As well, changes in current inventory items such as livestock, crops and feeds are included in determining gross income on the accrual basis.

During years when a business is growing and there are increasing inventories, the accrual method will report the value of the year's increase in income. This method of reporting income keeps income taxes current, but reduces the cash available for investment back into the farm business in expansion years.

Cash Method

The cash method is the most common way of computing farm income as it is basically very simple. Those amounts actually **received** in the year, other than capital items, are included in income and deductions are claimed for those expenses which were actually **paid** for in the year, again, other than for capital items. No accounting has to be made for inventories or accounts receivable, but neither can a deduction be taken for any unpaid bills (accounts payable) at the end of the fiscal year.

Generally speaking, for a young person starting out farming, or where a farmer is building up an existing business, it would be advantageous to use the cash method because:

- the increasing value of inventory is not taxed – the saved taxes are then available to finance future operating and expansion costs;
- high and low income years can be block averaged every five years, (see the chapter on income averaging);
- during non-averaging years, any annual losses can be carried back three years and forward ten years;
- livestock farmers can utilize the Livestock Inventory Provision to further even out income (see the chapter on income averaging).

Although these points have been discussed in the context of a cash basis farmer, certain of them would also apply to a farmer using the accrual method.

According to the Income Tax Act only taxpayers who have income from a farming or fishing business can use the cash method. This includes individuals, corporations, partnerships, and trusts which are in the business of farming. Also, by administrative practice, certain other persons who carry on business but do not have any inventory, work-in-progress or accounts receivable of any kind may also be able to use the cash method. **It should be pointed out that farming does not include such things as processing operations carried out in connection with a farming business or the receipt of a crop share under a sharecropping arrangement. Accordingly, income from these types of operations must be reported using the accrual method.**

Once you start with this method of income reporting, you must continue to use it each succeeding year. If, at any time, you wish to change from the cash basis to the accrual basis, you must obtain permission from Revenue Canada. If, however, you are using the accrual method and wish to change to the cash method,

you may do so without permission of Revenue Canada.

Considerations in Choosing a Fiscal Year End

An individual who is not self-employed is required to file an income tax return on income earned in the calendar year. When tax is payable, the tax return must be filed by April 30th of the following year. If no tax is payable, generally speaking, a return need only be filed if requested by the tax department, if you disposed of capital property, if you received a prepayment of child tax credit or if you had a taxable capital gain in the year.

In the first year of business, a sole proprietorship, partnership or corporation may choose a fiscal year which is different from the calendar year. In later years, the fiscal year may be changed after obtaining approval from Revenue Canada. By using a fiscal year other than the calendar year, the "business" income would then be reported in the calendar year in which the fiscal period of the business ended.

A non-calendar fiscal year can be advantageous in many cases from the point of view of tax deferral. Different types of operations will have different cycles on an annual basis as far as expenses and revenues are concerned. If a cash basis farmer were to choose a fiscal year end some time after most of the expenses have been paid, but before revenues are received, the farmer will essentially be able to defer payment of tax on the revenues for one year. It should be remembered, however, that financial planning and management may be affected by a fiscal year other than a calendar year.

A farmer should be aware that if the farming operation ceases and a fiscal year-end occurred in that calendar year, this would result in a short fiscal year lasting from the end of the previous fiscal year to the point of ceasing operations. In this situation, the farmer could have two fiscal year ends in the same calendar year. To illustrate this, assume a farmer had a fiscal year that ended on July 31, 1988. Further assume that the farmer decided to cease farming on October 31, 1988. The farmer would then have two fiscal years ending in 1988, one ending on July 31 and one ending on October 31, and would be required to report the income from both fiscal years in 1988. There is however, a relieving provision in this situation which would allow the farmer to **elect** to have the second fiscal year extended to the normal fiscal year end. In the example above, the second fiscal year end would be considered to run from August 1, 1988 to July 31, 1989, and the income from that fiscal year would be reported in 1989 instead of 1988.

Basic Filing Information

The following steps may be used as a guide to filing a tax return.

STEP 1: Compile farm income and expense statement – Form T2042 in the Farmer's Income Tax Guide or a similar statement.

Be sure to include items such as:

Income

- income from a woodlot if you cut and sell it yourself;
- applicable government grants and subsidies as income;
- surface rentals from petroleum and natural gas leases;
- income deferred in previous year with deferred cash purchase tickets for grain;
- full amount of taxable patronage dividends as income except for those received for personal goods and services.

Expenses

- wages paid to children or a spouse;
- capital cost allowance;
- dollar amount of livestock inventory included in income last year;
- the portion of a farm house used for business (i.e., office);
- the portion of car expenses that relate to business activities;

- deduction allowance on quotas in cumulative eligible capital account;
- the cost of bringing in public utilities if the utility company retains ownership of the capital assets (i.e., gas line);
- land improvements such as clearing and levelling as well as the cost of installing a land drainage system;
- depletion allowance on original costs of woodlots, sand and gravel pits if profits are being included in income;
- interest on cash advances levied under the Advance Payments for Crops Act or the Prairie Grain Advance Payments Act.

STEP 2: Calculate taxable income and tax payable.

Strategies if Taxable Income is Positive

- Review the level of capital cost allowance claimed – depending on your tax rates (high or low?) and also on future plans, you may want to adjust the level accordingly.
- Review non-capital losses from previous years and ensure that all losses of other years have been claimed to the extent possible. This will be further discussed in the section dealing with losses. NOTE: You cannot create a loss in the present year when claiming losses of other years.
- Consider if this may be the best year to block average.

Strategies if Taxable Income is Negative

- Review the livestock inventory provision. This may be used to:
  - utilize non-refundable tax credits;
  - claim maximum capital cost allowance;
  - take advantage of roughly the first $6,000 of taxable income which does not bear any tax;
  - utilize previous losses;
  - increase the benefit of a five year block average;
  - "borrow" income from next year in excess of what will be realized this year.
- Reduce the amount of capital cost allowance claimed for present year.
- Investigate the benefit of applying losses back three years and forward ten.
- Consider the benefits of block averaging.

Once the appropriate level of taxable income has been decided, the tables provided by Revenue Canada can be used to determine the amount of taxes payable. Individuals whose chief source of income is farming are required to make an instalment on account of their tax liability by December 31 of each year, with the balance to be paid by April 30 of the following year. Revenue Canada has forms available to assist in the calculation of the amount of the instalment payment.

SIMPLIFIED INDIVIDUAL TAX RETURN

FARM	PERSONAL AND OFF-FARM
+ Income	+ Net Employment Earnings
	+ Pension and Annuity Income
– *Expenses*	+ Registered Retirement Income Fund
	+ Investment Income
= Margin	+ Net Income from Off-Farm Self Employment
– CCA (Parts XI and XVII)	+ or – 2/3 Capital Gains or Losses
= Net Income from Farming	= Off-farm Income

= TOTAL INCOME

Less:

- Child care expenses
- Registered Retirement Saving Plan Contributions
- Other (Union/Professional dues, tuition)

= NET INCOME

Less:

- Losses from other years (farm losses, restricted farm losses, non-capital losses, net capital losses)
- Capital Gains Exemption

= TAXABLE INCOME

FURTHER STRATEGY AREAS INFLUENCING TAXABLE INCOME:

- 5 Year Block Average
- Livestock Inventory Provisions
- Other Deferrals (Rollovers)
- Deferred initial grain payment
- Partnership
- Corporation

Capital Cost Allowance

The cost of fixed assets such as machinery, equipment, vehicles and buildings cannot be deducted as an expense in one taxation year. Instead, the expenditures are considered to be of a "capital" nature and therefore, the cost must be spread over a period of years by taking a deduction based on the cost of the assets. The distribution of the cost of a fixed asset over its estimated useful life in a systematic manner is termed "depreciation". The term "capital cost allowance" is a tax term referring to the amount which Revenue Canada allows a farmer to deduct as depreciation in computing net farm income.

Under the pre-1972 income tax system, farmers could choose between two different methods for calculating capital cost allowance:

- the straight-line (Part XVII) method;
- the declining balance (Part XI) method.

Straight-line Method

The straight-line method allowed an equal amount of capital cost allowance to be claimed each year. The Income Tax Act established a percentage rate which is multiplied by the original cost of the asset to obtain the amount claimed each year. Under the present law, the straight-line method is being phased out. No capital assets purchased after December 31, 1971 may be written off using this method. However, assets which were owned on December 31, 1971 may be handled on the straight-line basis as long as the farmer remains in the business of farming and provided they have never been written off on the declining balance basis. The farmer may, however, at any time, transfer the undepreciated cost of a straight-line asset into a prescribed asset class under the declining balance basis, but once this decision is made, it is irreversible. As in the elimination of basic herds, to be discussed later, the phasing out of straight-line capital cost allowance will be a gradual process which will take a number of years to accomplish.

Declining Balance Method

Using the declining balance method, the capital cost allowance is equal to the "book value" of the asset multiplied by the percentage rate established in the Income Tax Act. Since the book value is reduced each year by the capital cost allowance claimed in the year, the amount ofcapital cost allowance claimed each year is smaller than that of the previous year.

When using the declining balance method, similar assets are grouped into classes and capital cost allowance is based on the cost of all assets in the class less amounts allowed in previous years as the capital cost allowance on these assets.

In the year that a depreciable asset is purchased, the CCA that can be claimed on that asset will be limited to one-half the regular CCA. This half-year rule applies to net additions in a year so that, where a farmer disposes of equipment, the restricted CCA claim will only apply to the cost of assets acquired less disposal proceeds of assets disposed. With this change in the rules, if a farmer is planning on acquiring equipment, it is best to acquire it before the end of a fiscal year instead of early in the next fiscal year. By accelerating the date of purchase, the farmer will be able to claim CCA on the asset that much sooner. To illustrate this, consider the case of a farmer who is planning to acquire a new self-propelled combine for $125,000 and has a fiscal year end of December 31, 1988. If the farmer acquires the combine before December 31, CCA of $18,750 could be claimed in 1988 and $31,875 in 1989. If the combine is acquired in January, 1989, nothing could be claimed in 1988 but $18,750 could be claimed in 1989. By purchasing the combine in 1988, the farmer has accelerated the claiming of CCA. Where a farmer is going to dispose of a piece of equipment the reverse would apply; defer the sale until after a fiscal year end.

Prior to May 24, 1985, when a taxpayer received a rebate directly from a third party manufacturer

on the purchase of an asset from an independent distributor, the capital cost of the asset did not need to be reduced by the amount of the rebate either for CCA purposes or for investment tax credit purposes. As a result of the May 23, 1985 budget, any rebates arising from the purchase of an asset must either reduce the capital cost of the asset or be included in income.

The mechanical rules for the two methods are familiar to most farmers and are adequately explained in the "Farmer's Income Tax Guide". It is appropriate, however, to provide a summary of some of the major similarities and differences in the two systems.

Flexibility in the Amount of CCA Claimed

Under either system, a farmer can choose to make a C.C.A. claim of any amount up to the maximum percentage allowed by the class (percentage rates vary from 1% to 100% depending on the asset). By using the maximum rate in a year of high income and a lower rate in a year of low income, a farmer can use capital cost allowance to the best advantage. A maximum capital cost allowance claim in each year may not always be the best tax management strategy.

Additionally, an advantage could be obtained by adjusting the order in which capital cost allowance is claimed. Consider claiming C.C.A. on assets in the following order: 1) straight-line assets; 2) class 6 assets; 3) class 8 assets; and 4) class 10 assets. The basic reasoning behind this is that if straight-line assets, which are not subject to recapture when sold, are not depreciated fully by the time they are sold, then the C.C.A. is lost. In comparing the different classes of declining balance assets, class 6 (10%) has a lower maximum yearly rate than class 10 (30%). It will take longer to write off the classes with the lower rates. Therefore, the balance in a higher rate class (e.g., class 10) can be preserved by not taking the maximum rate in a low income year and a larger CCA claim will be available in a high income year.

The result of depreciating the lower rate class first, and maintaining a larger undepreciated capital cost in the higher rate class, is that more CCA is available for high income years. Such a strategy would give more flexibility, but should be considered in terms of the particular situation.

An alternative strategy is available if it is expected that the farmer will have a good year in the near future. By making the maximum claim in a low income year, any resulting loss could be carried forward as discussed later, to offset income in the good year.

When considering a claim of less than the maximum amount, a farmer should consider claiming the maximum CCA and increasing the resultant net income via the flexible inventory provision. The reasoning for this is similar to the reason for claiming lower rate capital cost classes first. In effect, the livestock inventory provision is like a 100% rate class. That is, any amount included in income this year can be fully deducted next year.

Higher Initial Write-offs for Declining Balance Method

The maximum write-off rates for assets depreciated under the declining balance method are approximately twice as high as for assets depreciated under the straight-line method (Example: trucks are 15% on straight-line and 30% on declining balance). This means that, in the initial years, the declining balance basis will produce higher write-offs, but, in the later years, the write-offs will be lower than those under the straight-line method.

Differing Rules in the Year of Sale

When a straight-line asset is sold, capital cost allowance is claimed for the number of months it was owned. However, when a declining balance asset is sold, the proceeds simply reduce the balance in the class and the base on which further claims are taken.

"Recapture" and "Terminal Loss" of Capital Cost Allowance

If a depreciable asset is sold or traded, the proceeds of disposition up to the original capital cost reduce the tax base of assets of the particular class to which that asset belonged. As a result, the capital cost allowance deduction available for the year will be lower than it otherwise would have been. If the proceeds are greater than the tax base of the class, the excess is called "recaptured capital cost allowance". Under the declining balance method the full amount of recaptured C.C.A. is included in income.

A "terminal loss" is just the opposite of recapture. It results when all declining balance assets in a class are sold for proceeds less than the undepreciated values of the assets of that class. For example: a balance remains in the class, however, there are no assets remaining. A terminal loss is fully deductible from income in the year it arises.

Consider the following example:

	SITUATION 1	SITUATION 2
Original Capital cost of assets	$7,500	$7,500
Undepreciated Capital cost of assets in class	$6,000	$2,000
CALCULATIONS		
Undepreciated capital cost of assets in class	$6,000	$2,000
LESS:		
Proceeds of disposition	$2,300	$2,300
Revised undepreciated capital cost of assets remaining in class	$3,700	$ (300)

Situation 1: If we assume there is one remaining asset in this class and that we sell it for $2,300, we see that an undepreciated balance of $3,700 ($6,000 – $2,300) remains. This amount is a terminal loss and is deductible in computing net income for the years.

Situation 2: a) Declining balance assets: If this negative balance of $300 remains at the end of the year it must be added to net income for the year as **recaptured capital cost** allowance.
b) Straight-line assets: Under the straight-line method, each asset is treated separately. On the disposal of a particular asset any recaptured capital cost allowance will not be included in income, nor can a terminal loss be claimed.

As discussed earlier, a taxpayer can transfer the undepreciated cost of a straight-line asset into an asset class under the declining balance basis. Due to the differences in determination of recapture and terminal loss this transfer may provide tax planning opportunities when the circumstances of a farm operation are changing.

For example:

- Straight-line capital cost allowance is only permitted when the asset is used in the year for the purpose of gaining or producing income from farming. Accordingly, where the farm business is to be discontinued but certain assets are not being sold, conversion to the declining balance method should be considered. This conversion will permit the taxpayer to continue to claim capital cost allowance as long as the taxpayer continues in business.
- Where a sale of straight-line assets is planned at an amount less than the depreciated value, it may be beneficial to convert the asset to a declining balance class in order to claim the terminal loss on the subsequent sale.

Capital Gains and Capital Losses

Under either system, a capital gain on depreciable property could occur when sale proceeds received for an asset exceed the original cost of that asset. As a general rule, the capital gain is the difference between the original cost (or fair market value at December 31, 1971 if purchased prior to that time) and the fair

market value at the date of sale. A capital loss, however, will never arise from the disposal of depreciable property as proceeds received from the disposal of an asset, even if they are less than the original cost of the asset, are simply applied against the undepreciated balance of the CCA pool.

Transfer of Depreciable Property to a Spouse

Declining balance assets transferred to a spouse during the farmer's lifetime or on his death will generally move to the spouse at their undepreciated capital cost, and any recapture of capital cost allowance or capital gain will be postponed until sale of the assets by the spouse or until the spouse's death. Straight-line assets transferred to a spouse during a farmer's lifetime or on his death, will generally pass at their tax values ("adjusted cost base") and no capital gain, if any, will arise until the sale of the asset or until the spouse's death.

If the farmer so elects under the relevant section of the Income Tax Act, depreciable assets can be transferred to a spouse at the fair market value of the property. This provision would be useful in certain circumstances particularly where the spouse would continue to use the depreciable assets in an active farm business.

Transfer of Depreciable Property to a Child Under the Farm Rollover Provisions

Under the special "farm rollover" provisions, which are discussed later, declining balance assets can be transferred at the undepreciated capital cost of the assets. Recapture and/or capital gain is therefore deferred until such time as the property is sold by the child. Straight-line assets, however, can only be transferred to a child at their **fair market value**. No recapture results, of course, but it is possible that there could be a taxable capital gain if the proceeds of the sale are greater than the cost or V-day value of the assets. Once a child acquires the depreciable property, capital cost allowance must be taken on the declining balance method.

The above comparisons show some of the similarities and differences between the two methods of calculating capital cost allowance. Although there are factors of lesser importance to consider, the above points are a good guide in planning. As a general rule, most farmers should continue with the straight-line method wherever they can, and use the declining balance method only for those assets which they have acquired after 1971. This may require a little extra record keeping, but it could prove to be the most beneficial choice for the farmer. The ultimate measure of benefit between these two methods will, however, depend upon each farmer and the particular circumstances.

Investment Tax Credit

Tax Reform

At the time of writing, the Department of Finance had proposed new rules related to claiming C.C.A. These proposed rules are to take effect in 1990 and require an asset to be available for use in order to be eligible for C.C.A. In other words, the asset would be required to be on the farm and ready for use, not stored at the equipment dealer, for instance, if C.C.A. were to be claimed.

The Income Tax Act allows a taxpayer, whether an individual, a corporation, or a trust, to deduct from federal income tax payable an amount in respect of the investment tax credit at the end of the year.

The investment tax credit applies to many items included in a farmer's capital cost allowance schedule and purchased after June 23, 1975.

The credit covers new buildings used for the farm business, new farm equipment and new machinery used in the farm business. New farm trucks over 26,000 pounds gross vehicle weight used to haul outside a farmer's local area are also eligible for the investment tax credit. The tax credit does not apply, however, to cars, milk quotas, purchases of used machinery, computers, the cost of tile drainage, or a new farm home.

For investment tax credits earned before April 19, 1983, the amount of tax credit deductible is limited to the lesser of:

- the investment tax credit balance at the end of the year;
- the federal tax payable; and
- $15,000 plus one-half of the federal tax payable in excess of $15,000.

Effective in 1988 and subsequent years, the annual investment tax credit (I.T.C.) limit for tax-payers (other than corporations) is $24,000 plus 3/4 of the amount that the taxpayer's federal tax exceeds $24,000. This limit includes I.T.C.'s carried forward from prior years.

There is a requirement, though, that the capital cost of the asset for capital cost allowance purposes be reduced by the amount of the tax credit claimed in the prior year. In other words, if the investment cost is $20,000 and the tax credit claimed is $600, the undepreciated capital cost of the asset would be reduced by $600 in the year following the year in which the $600 credit is claimed.

Prior to May 24, 1985, when a taxpayer received a rebate directly from a third party manufacturer on the purchase of an asset for an independent distributor, the capital cost of the asset did not need to be reduced by the amount of the rebate, either for CCA purposes or for investment tax credit purposes. As a result of the May 23, 1985 budget, any rebates arising from the purchase of an asset must either reduce the capital cost of the asset or be included in income.

In the past, any unused investment tax credit could be carried forward for up to five years. However, any unused tax credit earned after April 19, 1983 and before 1989 can be carried back three taxation years and forward seven taxation years. Effective in 1989, investment tax credits earned after April 19, 1983 can be carried back three taxation years and forward ten taxation years.

When the investment tax credit was introduced in 1975, the basic rate was 5%. Since that time, there have been a number of changes to the rate and to the type of equipment that qualifies. The basic rate is now 3% with increased rates for certain low-growth areas of the country. For 1989 the basic rate will be reduced to nil. Detailed maps highlighting the boundaries of the various investment tax credit regions are contained in the Revenue Canada Information Circular IC 78-4R3.

Applying the Investment Tax Credit

The following example illustrates how the investment tax credit works.

Assume:

- A farmer purchases a new tractor for $60,000 (Class 10) in 1988.
- Taxable income is $32,000 (before CCA is claimed for new tractor).
- The capital cost allowance on the purchase price of the tractor is: $60,000 x 0.30 x 0.50 = $9,000
- The investment tax credit (3%) will be: $60,000 x 0.03 = $1,800
- The capital cost for CCA purposes is:
  Purchase Price $60,000

The net position after tax in each case will be:

	Without Tax Credit	Using Tax Credit
Taxable Income	$32,000	$32,000
CCA on Tractor	9,000	9,000
Net Taxable Income	$23,000	$23,000
Federal Tax Payable	$ 3,910	$ 3,910
Investment Tax Credit	—	1,800
Net Federal Tax	$ 3,910	$ 2,110
Provincial Tax	$ 1,818	$ 981
Total Tax	$ 5,728	$ 3,091

The net tax savings as a result of the investment tax credit is $2,637.

In 1989 the undepreciated capital cost of the tractor will be $60,000 (purchase price) less $1,800 (I.T.C. claimed) less $9,000 (C.C.A.) = $49,200.

The Income Tax Act provides for a refund in certain circumstances of the investment tax credit earned. To the extent that the investment tax credit is earned on property acquired after April 19, 1983 and is not used to reduce federal tax payable in the year of acquisition, a farmer and certain farm corporations can claim a refund equal to 40% of the unused credit earned in the year. Investment tax credits earned in a year are considered to be claimed before any carryover from another year. Any refund claimed will reduce the amount available for carryover to another year as well as reducing the capital cost of the asset acquired in the year following the year the claim for a refund is made.

The following example illustrates what happens when the investment tax credit earned in 1988 exceeds the federal tax payable for that year. The assumptions from the previous example are used, except that taxable income has been reduced to $14,883.

Since there is insufficient federal tax payable, the ITC claim will be less than the maximum. In this case the proper result is:

Purchase price = Adjusted Cost	$60.000
CCA on Adjusted Cost: $60,000 x 0.30 x 0.50 = $9,000	
Taxable Income	$14,883
CCA on Tractor	9,000
Net Taxable Income	$ 5,883
Federal Tax Payable	$ 1.000
Investment Tax Credit	1.000
Net Federal Tax	0
Provincial Tax	465
Total Tax	$ 465
Refund Calculation:	
ITC on this year's purchase	$ 1,800
ITC claimed	1,000
ITC eligible for 40% refund	800
40% Refund	$ 320
Amount of ITC that can be carried over is:	
ITC on this year's purchase	$ 1,800
ITC claimed & refunded— ($1,000 + $320)	1,320
ITC amount eligible for carryback or forward	$ 480

Note: To the extent any amount is carried back to a previous year, it will reduce the base for claiming CCA in 1988 and will accordingly affect the above calculations.

Investment Tax Credit in a Farm Partnership

In a farm partnership, any investment tax credit earned in the year is divided among the members of the partnership according to each member's partnership interest. This allocation of

the tax credit to individual partners is done at the end of the partnership year. The capital cost of each asset, for which an investment tax credit was earned must be reduced for capital cost allowance purposes by the amount of the tax credit allocated to the partners for that asset.

Investment Tax Credit in a Corporation

As long as the qualifying assets were purchased by the farm corporation, the calculation of the tax credit in determining the corporation's taxes is similar to that for an individual. There are certain provisions that, in effect, will allow a corporation to flow out to a shareholder a portion of the investment tax credit balance which the corporation cannot use.

Provisions were introduced in the May, 1985 budget which restricted the carryover of unused investment tax credits if a change in corporate control occurs after May 23, 1985. These provisions will also restrict the carry back of investment tax credits earned after a change in corporate control against taxes for years prior to the change in control.

If additional information is required concerning this procedure, a tax advisor should be consulted.

Tax Treatment of Basic Herds and the Unit Price Method

This chapter will discuss briefly how the federal income tax laws deal with basic herds and the unit price method.

The chapter on farm losses deals with the laws as they relate to inventories when a farmer is required to calculate the Mandatory Inventory Adjustment. The chapter on income averaging deals with the laws as they relate to inventories when a farmer elects to use the flexible inventory provision.

Livestock Inventories

These assets will be dealt with under two separate headings: "basic herds" and the "constant unit" election. As time goes on, and the tax system matures, tax problems involving basic herds will gradually disappear and questions regarding the other system of accounting for livestock will replace them. However, basic herds will be around for some time yet, so it is important to understand the rules.

Basic Herds

This term was used under the pre-1972 tax system and applied to certain specified groups of animals (cattle, horses, sheep or swine) owned by a farmer. Once a basic herd of a class was established for income tax purposes, the cost of additions to the basic herd was not deductible, and the proceeds from reduction of the basic herd were not taxable. In other words, the herd was recognized as a capital asset in somewhat the same way that plant and equipment are capital assets to a manufacturing business. It is interesting to note that the "basic herd" concept was not authorized by law under the pre-1972 tax system, but was strictly the result of the practice of the tax authorities. In the new tax system however, while "basic herds" are now defined, they are also being eliminated with the passage of time. No new basic herds can be established, nor can existing ones be increased.

Special transitional rules have been established to phase out those basic herds which have been allowed to carry over into the new system.

Simply stated, the transitional rules provide two different ways in which this phase-out of existing basic herds will be accomplished: the "mandatory" reduction and the "optional" reduction.

The Mandatory Reduction. As a general rule, if a herd of animals at the end of a taxation year consists of less than the approved basic herd number, the farmer's approved basic herd must be reduced to the lower figure. The farmer must then take a deduction from his income representing the amount of this reduction. The formula for this deduction is:

Number of animals by which basic herd was reduced	X	Average of the fair market value of all the animals in that class at December 31, 1971

= Deduction from income

If a farmer with a basic herd wishes to ensure that the mandatory reduction in the basic herd is not applicable, then the number of animals in that herd class should not be less than the number of animals in the basic herd for that class of animal. If this is done each year, the basic herd can be continued indefinitely in the new tax system.

Optional Reduction. If a farmer does not have a herd decrease which brings the mandatory reduction into effect, the choice of using the optional reduction still exists. These rules allow a farmer to write off each year, for tax purposes, a maximum of one-tenth of the December 31, 1971 fair market value of the basic herd. In fact, the amount of the deduction which will be allowable may be less than one-tenth since it cannot exceed the least of the following three amounts:

- the number of animals of the class disposed of in the year;
- 10% of the "basic herd" at December 31, 1971; or
- the number of animals in the "basic herd" at the end of the preceding year.

The least of these three amounts is then multiplied by the average of the fair market value of all the animals in that class at December 31, 1971.

Farmers should also note that, where a write-off of 10% of the basic herd is available, **it does not have to be taken in full**. Any amount less than 10% could be taken for the year. A farmer might need to take only 5% write-off, for example, to reduce taxable income to nil. Or, in a year of relatively low income, a preference may be not to take any write-off and save the deduction until future years when profits are higher.

At the time of tax reform, Revenue Canada prepared an excellent summary of the basic herd rules, together with illustrative examples, in a booklet entitled, "Basic Herds". Every farmer who accounts for any livestock on this basis should have a copy of this publication as a guide to the tax treatment of purchases and sales.

V-Day Values. For those farmers who have not established the December 31, 1971 market value for their basic herd, it should be done as soon as possible. As in the case of other "V-Day" valuations, the higher the value assigned to the animals, the greater the tax advantage when the animals are disposed of, but the values must be reasonable and supportable to be accepted by the tax authorities.

Basic Herds on Death or Cessation of Business. Consider the situation where at the time of a farmer's death, the livestock herd had a fair market value of $150,000, and the value of the "basic herd" at December 31, 1971 (which had not yet been expensed for tax purposes) was $80,000. In the final income tax return of the farmer, $150,000 must be shown as income, but this will be partially offset by the deduction of $80,000 as the value of the basic herd. Legal representatives who look after the deceased farmer's affairs should be aware that a separate tax return can be filed to report this type of income. A second set of personal exemptions can then be claimed on this return.

As an alternative, the legal representative may, within certain time limits, transfer the ownership of the basic herd to the spouse or children of the farmer who are beneficiaries of his estate.

If this is done, the cost to the beneficiary for tax purposes will be considered to be an amount equal to the fair market value of the basic herd at December 31, 1971, minus any amounts deducted previously from the basic herd by the deceased. Upon sale, the beneficiary will include only the excess of sale price over the basic herd value transferred. A beneficiary who inherits basic herd animals will not be permitted to carry on with the basic herd concept.

When a farmer goes out of business and the herd is sold, the full amount of proceeds from the sale must be included in income but a deduction will be allowed for the basic herd value which has not yet been expensed. The tax on this net difference could be lessened through the use of block averaging.

Miscellaneous Comments on "Basic Herds". There are some additional points that should be made regarding basic herds. The first point, already mentioned but worth emphasizing, is that, even though the basic herd is treated like a capital asset, increases in the value of the animals are not treated as capital gains (two-thirds taxable) but as ordinary income (fully taxable). Second, basic herds were available under the pre-1972 tax system not only to cash basis farmers but also to farmers who used the accrual method of accounting. This practice has been continued under the present rules, and Revenue Canada's booklet shows how the calculations would be made. Farming corporations, provided they had established their basic herds by the date their 1971 income tax returns had to be filed, are also entitled to use the basic herd rules in the same manner as individual farmers. Although farming partnerships would not be entitled to have basic herds (since

a partnership entity is technically not a taxpayer) each individual partner could have an approved basic herd within the partnership.

Remember to claim any remaining basic herd exemption at the time of an estate disposal, sell out or change in business arrangement.

The Unit Price Method for Farmers Who Are on the Accrual Basis

Farmers are entitled to use the accrual method or the cash method in computing income for tax purposes.

In a period when the value of livestock is rising it is possible that profits calculated on the accrual basis may be high, purely as a result of the value of a farmer's inventory. It is conceivable that a farmer could show a profit on which tax is payable without having cash with which to pay such taxes, since the profit for the year may be represented by an unrealized increase in the value of inventory. In recognition of this type of problem, the government has provided a special election for farmers who report income on the accrual basis.

This election enables them to report their inventory at a unit price that remains constant from one year to the next. The result is that the variations in the livestock inventory values are removed, and the farmer's income for tax purposes closely mirrors the cash flow for the year.

The election is available to any person in the business of breeding and raising animals but may not be used with respect to registered animals, feedlot operations or animals bought for resale. The election is made by filing special form T2034 with the income tax return for the year in which the constant unit value is adopted.

Reporting Cash Advances and Deferred Income

The receipt of cash advances and deferral of certain farm receipts have come under review by Revenue Canada. The procedure for handling these items is outlined below.

Cash Advances

Revenue Canada has changed its policy regarding advances under the Advance Payments for Crops Act or the Prairie Grain Advance Payments Act. In the past these advances have been treated as income when received and the repayment as an expense. The proper reporting procedure now is to handle the advance as a loan. Therefore, for 1985 and subsequent years, any advance received will be nontaxable, however, when grain is sold to repay the advance, the sale would be reported at the gross amount before reduction for the repayment of the advance.

It should be noted that refunds of levies under the Western Grain Stabilization Act are to be considered income of the year in which they are received.

Deferred Cash Grain Tickets

The use of the "deferred cash grain ticket" provides a means by which crop inventories can be sold in one year but not subject to tax until the subsequent year. The use of these tickets is described in the Farmer's Income Tax Guide.

> "When you deliver grain to a licensed public elevator or process elevator, you may receive a storage ticket, a cash purchase ticket or a deferred cash purchase ticket. If a storage ticket is issued, no sale has taken place and therefore you have not received income at that time. If a cash ticket is issued, a sale has taken place and you are considered to have received payment at that time, regardless of when the ticket is presented for payment.
>
> If a deferred cash purchase ticket is issued, and the ticket provides for payment at a date that is after the end of the fiscal period in which the grain is delivered for sale, you may be eligible to report the purchase price stated on the ticket as income in the immediately following fiscal period. This deferral of income is only available in certain circumstances which are explained in Interpretation Bulletin IT-184R entitled 'Deferred Cash Purchase Tickets Issued for Grain'."

The use of a deferred cash purchase ticket enables a grain farmer to take advantage of the price prevailing at a particular point in time while deferring the income for income tax purposes. This rule is only available, however, to grain farmers who use the cash method of accounting for their income.

Although the income is not reported until the date on the deferred cash purchase ticket, the ticket can be used to obtain a deduction in the current year. If a supply dealer accepts the ticket as a payment on the account, this will result in a deductible expense for the current year, as the farmer will be considered to have made a payment in that year. The dealer will receive the cash on the maturity date of the deferred cash purchase ticket, but the farmer must remember to include the deferred cash purchase ticket as income in the subsequent year. Western Grain Stabilization levies can be deducted at the time the grain is delivered for sale even though the sale is not taken into income until the following year.

Crop Insurance Proceeds

Amounts received as compensation for crop losses are considered to be income when received. Revenue Canada has adopted the policy of allowing for a deferral of the reporting of such proceeds if the insurance company agrees to defer payment of the proceeds until a subsequent fiscal year. In this way if farmers are in a position to defer the receipt of such proceeds they will not be taxed until the subsequent year.

Deferred Livestock Sales

It has been accepted as common practice that people who want to defer their livestock sales may do so, in nearly all cases. A postdated cheque may be received for part or all of any livestock sold. From the buyer's perspective, Revenue Canada does not allow the buyer to deduct the purchase until the year the postdated cheque is cashed. However, Revenue Canada does not allow deferrals when payment is made by a certified postdated cheque. The deferral of a certified postdated cheque is not allowed because, being certified, the funds have left the issuer's account and are being held in trust by the bank. A non-certified postdated cheque on the other hand, is really only a "promise" to pay in the future and only represents evidence of a contract.

Use of this deferral strategy is probably limited to sales through auction marts and bonded livestock dealers. This is because most sellers will consider the auction mart or bonded dealer a better risk than other individual buyers. Secondly, the auction mart or dealer usually operates on a different fiscal year end than December 31.

The procedure to follow would be for a buyer to pay for the cattle and receive a deduction as the funds clear his bank. The seller receives the deferral as the auction mart provides a postdated cheque for payment, cashable in the new year. Since the auction mart's year end is not December 31, this transaction will balance during **their** business year. Revenue Canada appears to have finally sanctioned what has been the practice for a good number of years.

Tax Deferral Program Details Announced for Sales of Breeding Livestock Due to Drought

On December 12, 1988, Michael Wilson, the Minister of Finance, released draft legislation to implement the tax deferral program for farmers who were forced to sell their breeding herds of livestock due to drought conditions. The program was first announced on June 30, 1988. The income tax amendments will permit farmers to deduct a portion of the proceeds of sale of breeding animals from their incomes in a drought year and to include that amount in their incomes in the following year.

The amount of income that can be deferred will increase, depending on the reduction in a farmer's breeding herd from the beginning to the end of the farmer's taxation year. The tax deferral will be available where a farmer's breeding herd has been reduced by 15% or more. Where the herd has been reduced by 15% or more, but less than 30%, the farmer may defer 30% of the proceeds of sale of breeding animals to the next year. Where the herd has been reduced by 30% or more, 90% of such proceeds may be deferred. It is important to note, however, that the proceeds of sale of breeding animals eligible for the deferral are to be net of the cost of any breeding animals acquired in the year. In other words, the deferral will only apply to the difference calculated after subtracting purchases of breeding animals from sales of breeding animals.

In order to calculate your eligibility under this program, it is important that a number of definitions under the draft legislation be clarified. These definitions are as follows:

- "Breeding animal" means: a) horses that are over 12 months of age and are kept for breeding in the commercial production of pregnant mare's urine and b) bovine cattle, bison, goats and sheep that are over 12 months of age and kept for breeding.
- "Breeding Herd" means: the number determined by calculating the total number of a taxpayer's breeding animals at the beginning and end of a year (cows and heifers over 12 months of age). The formula for calculating the size of a farmer's breeding herd includes a requirement that the number of heifers in the herd does not exceed 50% of the number of cows in the herd. The following example illustrates the calculation required.

Inventory on hand	Jan. 1, 1988	Dec. 31, 1988
Cows	80	50
Bred heifers more than 12 months old	40	25
Open heifers less than 12 months old	30	10
Breeding herd		
Cows	80	50
Heifers more than 12 months old	40	25
	120 head	75 head

Income Deferral Percentage. After calculating the opening and closing inventory breeding herd numbers, the deferral percentage can be calculated. In the above example, the reduction of 45 breeding animals (120 opening value less 75 ending value = 45 head) results in a percentage reduction of 37.5%

$$\frac{45}{120} \times 100 = 37.5\%$$

Since the reduction is greater than 30%, this producer would be eligible for a deferral of 90% on the proceeds of sale of all breeding animals net of any amount paid to acquire breeding animals in the year.

Net Eligible Income. Expanding the example, assume the producer had sales of 40 cows and 10 bred heifers (over 12 months of age) and had purchased 10 cows. The sale price of the cows and bred heifers was $800 and $1,000 respectively and $1,000 for the purchased cows.

Sales	
Cows (40 head x $800)	$32,000
Heifers (15 head x $1,000)	15,000
	47,000
Purchases	
Cows (10 head x $1,000)	(10,000)
Net Sale Proceeds of Breeding Animals	$37,000

Income Deferral Amount. The eligible income for deferral into the subsequent taxation year is calculated as follows:

Net eligible income x income deferral percentage

$37,000 x 90% = $33,300

Using this example, this producer could elect to deduct from his farm income $33,300, which would be included in computing his farm income in the immediately following taxation year.

Other Program Details

- For the 1988 calendar year, the provinces of Alberta, Saskatchewan and Manitoba will be designated as drought regions — all producers in these regions potentially therefore qualify for the program in 1988.
- If in 1989 the federal Minister of Agriculture determines that a specific area is suffering from drought, then the one-year deferral may be extended to the subsequent taxation year. This extension may continue for a series of periods, depending on the area being continuously classified as a drought area.
- The program is only a deferral of income; therefore, there is no requirement to purchase livestock in the subsequent taxation year to offset the deferred amount. Due to anticipated verification problems for cattle repurchases, any requirement to repurchase breeding animals has not been incorporated into the rules.
- There does not appear to be any limitation for the sale of breeding animals to non-arm's length parties. In other words, a sale of breeding animals between parents and children would appear to be eligible.
- This deferral program is not available for a year in which a taxpayer dies or where the taxpayer becomes a non-resident of Canada.

Conclusion. The program will assist producers who experienced a herd reduction due to drought conditions. It is important to realize however, that this program only provides for a one-year income deferral and is not an absolute reduction of taxable income. As this draft legislation is quite complex, it is very important that the advice from a qualified accountant be sought to determine your net eligible sales and your percentage deferral in calculating your deferral eligibility.

Capital Gains

The most significant change brought about by Canada's 1971 tax reform was the taxation of capital gains. Virtually every Canadian owning property was affected by this decision of the policy makers who developed the new Income Tax Act. Canadians have since gradually become accustomed to using the phrase "Valuation day" or simply "V-day" as the day on which the measurement of all capital gains subject to tax would begin. Two valuation days were established:

- December 22, 1971, for publicly-traded shares and securities;
- December 31, 1971, for all other types of capital property.

Essentially, any gain accrued prior to V-day is exempt from tax, but any gain arising after V-day is subject to tax. The same principle applies with regard to the deduction of capital losses. The controversy surrounding the taxation of capital gains resulted in a policy that only **three-quarters** of the amount of a capital gain is taxable and only **three-quarters** of a capital loss is deductible. (The ratio is two-thirds for 1988 and 1989. Prior to 1988 the ratio was one-half.)

The immediate implications of taxing capital gains are fairly simple. If **capital property** was owned at V-day, or acquired after that date, it is likely that the property will be disposed for proceeds which are either more or less than V-day value or cost. The resulting capital gains or losses will create a tax cost or tax saving in the year in which the disposition is made.

What is Capital Property?

Capital property includes, under normal circumstances, the following common types of assets which a farmer might own:

- farmland and improvements such as drainage and fences;
- buildings;
- machinery, equipment, vehicles, etc.;
- farm homes;
- stock, bonds and other securities;
- personal use property such as boats, summer cottages, automobiles and other assets of this nature;
- certain items specified as listed personal property: coins, stamps, rare books, jewellery, drawings, paintings or sculptures.

A host of special rules exist with regard to the tax treatment of capital gains and losses on these various kinds of assets. As well as the above list, which is not all-inclusive, a farmer will also have to determine the gain or loss for the following properties:

- basic herds;
- milk quotas or other "government rights" or licences of a similar nature.

Studies have indicated that, on the average, Canadian farmers have two-thirds of their assets tied up in farmland alone. The need, therefore, to maintain accurate cost records for all property, including property acquired after valuation day and the V-day valuation of property held at December 31, 1971 is very important.

What is a Disposition of Capital Property?

A **disposition** includes a number of circumstances in addition to the simple sale of property to a third party. A disposition will occur for income tax purposes if one of the following events occur:

- property is sold;
- property is gifted;
- the owner of the property dies;
- property is taken unlawfully;
- property is expropriated;
- property is destroyed and insurance proceeds are received;

- property is transferred to a trust, corporation or partnership.

This checklist is not all-inclusive, but it covers the more common situations. Farmers have received special consideration with regard to certain dispositions relating to the family farm through the Family Farm Rollover Provision. With the introduction of the $500,000 lifetime capital gains exemption, the effect of these rules is to **postpone** tax on property transferred via the family farm rollover provision or potentially exempt property transfers from tax through the use of the $500,000 capital gains exemption. The existence of these provisions makes the need for V-day values very important.

Valuation Day Values

Although there is a tendency to defer determining V-day values until a disposition of the property takes place, the time to establish these values is **now**. In establishing these values, it is important to consider the following factors:

Inflation. Property values may have risen since V-day and will probably continue to do so. For some assets, such as real estate, values are changing almost daily. Establishing the value at a particular point in time will become more difficult the longer the valuation is delayed.

Documentation. Documentation which can provide support for asset values at December 31, 1971 is still available, but, with the passage of time, this evidence (such as news articles, advertised prices for similar assets, etc.) becomes much more difficult to obtain. Consider, for example, published list prices and trade-in values for farm machinery.

Photographs. These may be used to portray the condition of an asset at or near valuation day. Pictures can be of great assistance in cases where an asset changes over a period of years. An example might be a parcel of land adjacent to a deep gully in which serious erosion was taking place. The land might have had considerable value at V-day but be virtually useless as farmland at the date of disposition many years later owing to the erosion. A photograph taken near V-day could provide excellent support for a relatively higher V-day value.

Information Regarding Neighbouring Properties. A record of the selling price of neighbouring or similar properties provides a strong guideline for the value of a particular property. It is much easier to compile this information now than many years hence. Comparable sales information may be available from Revenue Canada.

Knowledgeable Persons Who Can Provide Information or Opinions. Although no one knows more about a farm than the owner, if the farmer dies without documenting this, the value of this intimate knowledge of the farm will be lost. Persons with a working knowledge of real property values in a given area at December 31, 1971 also may not be available when a property is ultimately disposed of. Getting a letter of opinion from them now is important, as it may not be possible when the need for it arises.

Getting An Appraisal. The above comments have all related to farmers who wish to establish V-day values themselves rather than have a formal appraisal done by a professional appraiser. Appraisals are expensive, but are important in cases where the value of a farmer's property is substantial. Farmers with property valued in excess of $100,000, for example, are well advised to get a formal appraisal. This is especially true in areas of urban influence. The accredited appraiser's job is a difficult one, but it will never be any easier than it is now.

Estate Settlement. The handling of a person's estate will be considerably easier if the deceased person has V-day values on hand for all the property. Farmers should treat this as seriously as making a will.

Rollovers of Property to a Spouse or Children

The general concept of the rollover provisions is that the recognition of a capital gain or a recapture of capital cost allowance is deferred. Tax will not be payable until the death of a

surviving spouse or until the property ceases to be passed from one generation to the next. It is possible that a family farm could be operated for a number of succeeding generations before the time finally comes for the tax to be paid. Who will be around in the year 2084 to determine what the property was worth December 31, 1971? Take steps **now** to establish pertinent V-day values.

Determining Valuation Day Values. As noted above, a farmer can obtain the services of a professional appraiser to establish this value. The cost of getting an appraisal could amount to several hundred dollars. It is important to note that such an expenditure is not deductible as a business expense, nor can it be used to reduce the amount of capital gain which will ultimately arise on disposal of the property. Nevertheless, a professional appraisal provides valuable evidence when a taxpayer is defending the V-day value should it be disputed by Revenue Canada.

A Final Note On Valuation of Farm Property. A natural question for a person to ask is, "How are the tax authorities going to know what my farm was worth at V-day". The answer is two-fold. Revenue Canada maintains a staff of experts in the field of appraisals and business valuation. Additionally, Revenue Canada has compiled detailed information on real estate transactions all across Canada which took place close to V-day. This information is available to assist a tax assessor in determining whether or not the V-day value which a farmer reports is reasonable.

This data has been computerized and made accessible to all who need it. The information assembled is known as the Real Estate Data Bank. Enquiries regarding the Real Estate Data Bank can be directed to your District Taxation office.

It should be emphasized that the Real Estate Data Bank will not contain actual appraisals of properties sold in 1971 or 1972, and will not contain information on any properties other than those sold in those years. The Data Bank will only contain information which may be helpful in establishing the Valuation Day values of properties at some future date.

It should be emphasized that the Data Bank information is no substitute for the information which taxpayers can gather on their own property. The bank data will provide only rough guide-posts to values, and both the taxpayer and the department will be dependent in large measure on the information which the farmer is able to obtain.

Clearly, a farmer should determine a V-day valuation with proper documentary support. This will prevent Revenue Canada from establishing their own value which the farmer will have to accept. Their value may be neither as accurate nor as advantageous as the one which a farmer would determine. Remember, if the value is ever questioned, the onus is on the farmer to substantiate it.

Calculation of Capital Gains

As mentioned previously, the general rule is that two-thirds of the amount of a person's total capital gains, less two-thirds of their capital losses, is included in income for tax purposes for the 1988 and 1989 taxation years. This rate will increase to three-quarters for dispositions of property occurring in 1990 and subsequent taxation years. The basic system for determining a capital gain on the disposition of property is as follows:

Proceeds of Disposition – 1989		$120,000
Less: Adjusted Cost Base	$ 23,600	
Plus: Outlays and Expenses	400	
		$ 24,000
Capital Gain		$ 96,000
TAXABLE CAPITAL GAIN (2/3 X $96,000)		$ 64,000

Assuming there are no capital losses, the taxable capital gain of $64,000 would be added to income and taxed at normal rates. If the taxpayer qualified for the capital gains

exemption, the rules and regulations may result in this taxable capital gain being exempt from tax. (See the chapter on $500,000 lifetime capital gains exemption.)

There are two methods which could be used in determining the adjusted cost base of property held on December 31, 1971. The first, called the median rule, is based upon the original cost or purchase price of the property, the valuation day value of the property, and the proceeds of disposition. The middle of these three values will be used as the adjusted cost base of the property for computing any capital gain or loss. The second method is the Valuation Day rule.

Under this method, the V-day value is used as the adjusted cost base for determining all capital gains and losses. The Valuation day method is not available to corporations and thus the median rule must be used for capital property owned on December 31, 1971.

Once individuals elect to use the Valuation Day value, they must continue to use it for all dispositions of capital property owned on December 31, 1971. Similarly, if the median rule is elected, it must continue to be used on all dispositions of capital property owned on December 31, 1971. It is not possible to switch from one method to the other.

The following table will assist in understanding these two options:

	A	B	C	D	E
Original Cost	$10,000	$15,000	$12,000	$13,000	$10,000
Valuation Day Value	13,000	11,000	10,000	12,000	12,000
Proceeds Disposition	20,000	13,000	14,000	10,000	9,000
ADJUSTED COST BASE					
(i) Median Rule	13,000	13,000	12,000	12,000	10,000
(ii) Valuation Day Rule	13,000	11,000	10,000	12,000	12,000
CAPITAL GAIN (LOSS)					
(i) Median Rule	7,000	nil	2,000	(2,000)	(1,000)
(ii) Valuation Day Rule	7,000	2,000	4,000	(2,000)	(3,000)

In situation A, the middle value is the valuation day value. For both methods, the capital gain will be the difference between the proceeds of disposition and the V-day value. In situation B, the middle value is equal to the proceeds of the disposition. No capital gain is, therefore, realized under the median rule. Under C, the original cost is the middle value. Here a loss accrued before V-day, but a recovery greater than this loss was made. A capital gain of $2,000 is realized using the median rule. The V-day method gain of $4,000 is the difference between proceeds of disposition and the V-day value.

Situation D shows a capital loss of $2,000 where the median rule adjusted cost base is $12,000. This is also the V-day value. In situation E, the middle value is the original cost. The loss here is the difference between the original cost and proceeds of disposition. The loss using the valuation day rule is the difference between V-day value and proceeds of disposition.

Three-quarters (two-thirds in 1988 and 1989) of these capital losses, realized on dispositions of capital property, are called allowable capital losses and may be deducted against taxable

capital gains realized in the year. Remaining allowable capital losses should be carried over to other years to apply against taxable capital gains.

Election to use the valuation day value as the adjusted cost base of property held on December 31, 1971 must be made in the return of the year in which the taxpayer first disposes of capital property other than:

- depreciable property;
- an interest in partnership;
- a personal use property that is not listed personal property or real property;
- a listed personal property if the gain or loss is nil because of the $1,000 rule;
- a principal residence if the gain is nil.

The implication of this is that, once a method of determining the adjusted cost base on capital property owned on December 31, 1971 has been selected, it must continue to be used on other assets owned on V-day, except those listed above.

A person may reduce the capital gain by the amount of any expenditure necessary to make the property saleable. This is termed outlays and expenditures, and includes such items as fix-up costs, cleaning, real estate commission, and legal fees.

It is important to note that, for property acquired after December 31, 1971, the adjusted cost base will normally be the purchase price of the property. Special rules apply to property acquired from a related person who owned the property on V-day. In certain situations, the person who acquired the property may be deemed to have owned the property on V-day and could inherit the previous owner's actual cost. For this reason, the history of any property disposed must be considered to see if it falls within the rules.

Capital Gain Reserves

When a farmer does not receive all the proceeds of disposition in the year of the sale of a capital property, it is possible to deduct a reserve based on the amount of proceeds not due until after the year end. Where a reserve is deducted in one year, it must be included in income in the following year and another reserve taken if some of the proceeds are still not due until after the second year end. The amount of the reserve is equal to the capital gain multiplied by the amount of proceeds not due until after the year end and divided by the total proceeds. Additionally, on a cumulative basis, at least one-fifth of the capital gain must be recognized each year.

The maximum capital gain reserve is the lesser of:

(A) $\dfrac{\text{Balance of Principal Unpaid}}{\text{Total Transfer Price}}$ x Capital Gain

(B) $\dfrac{\text{Capital Gains}}{\text{Maximum Term}}$ x Remaining Term

The following example serves to illustrate this calculation. Assume a farmer sold a piece of land in 1982 for proceeds of $100,000 and the capital gain otherwise calculated was $70,000. The payment schedule called for $30,000 in the first year and the balance over a seven-year period.

Therefore in 1982:

$$A = \frac{\$\ 70{,}000}{\$100{,}000} \times \$70{,}000 = \$49{,}000$$

$$B = \frac{\$70{,}000}{5} \times 4 = \$56{,}000$$

As a result the maximum reserve allowed is $49,000 and the capital gain recognized in the year is ($70,000 – $49,000) = $21,000. Although the payment is spread over seven years, the capital gain is realized in five years.

CAPITAL GAIN RESERVE CALCULATION

Year	Annual Payment Received	Cumulative Receipts To Date	Reserve Based On Proceeds Not Due (A)	Reserve Based On Recognized Gain (B)	Reserve (lesser of A or B)	Annual Gain Recognized
1982	$30,000	$ 30,000	$49,000	$56,000	$49,000	$21,000
1983	10,000	40,000	42,000	42,000	42,000	7,000
1984	10,000	50,000	35,000	28,000	28,000	14,000
1985	10,000	60,000	28,000	14,000	14,000	14,000
1986	10,000	70,000	21,000	0	0	14,000
1987	10,000	80,000	14,000	0	0	0
1988	10,000	90,000	7,000	0	0	0
1989	10,000	100,000	0	0	0	0

Where certain property has been transferred by a parent to a child, the requirement to recognize a capital gain over five years is increased to a ten-year period. The property that qualifies for this treatment includes land or depreciable property used in Canada in a farming business, shares of a family farm corporation or a small business corporation, or an interest in a family farm partnership. The definition of these terms will be dealt with later.

It should be noted **that there is no reserve for recaptured Capital Cost Allowance when selling depreciable property such as buildings or machinery**. It is very important to understand this rule as many farmers wish to transfer their equipment to their children by carrying a debt payable over a number of years. Since there is no reserve available, the entire recaptured capital cost allowance figure will be deemed income in the year of sale regardless of the amount received from the purchaser. When transferring depreciable property an accountant should be consulted in order to determine the tax effect of such transfers.

Tax Treatment of the Farm Family Home

From the foregoing discussion, it can be seen that, as a general rule, 3/4 (2/3 in 1988 and 1989) the amount of a person's total capital gains, less any allowable capital losses, are included in income for tax purposes. Any gain that an individual realizes when a principal residence is sold, however, is still tax free in most cases. The rules regarding principal residences have become quite complex where two principal residences are owned. To provide some general guidance on this topic, the following discussion attempts to respond to a few basic questions of interest to farmers.

What is a Principal Residence for Tax Purposes? Four different requirements must be met before a property will qualify as a principal residence on which the capital gain will be tax free.

Housing Unit. The property must be a housing unit (or a leasehold or share in a housing co-op). This could be a house, apartment, condominium, cottage, mobile home, trailer or houseboat. Also included is the land on which the dwelling stands. The amount of land which will be allowed is only that land which "contributes to the use and enjoyment of the housing unit".

What does this mean in practical terms? Up to one acre (one-half hectare) will be accepted without question. If the claim is made that more

than one acre contributes to the "use and enjoyment" of the home, it will have to be proven to the taxation authorities. Several factors will be considered in allowing such a claim. These are set forth in paragraphs 11 to 14 of Revenue Canada's Interpretation Bulletin, IT-120R3.

Ownership. The property must be owned by the taxpayer, either solely or jointly with another person. The most common form of joint ownership is joint-tenancy of husband and wife.

Ordinarily Inhabited. The property must be ordinarily inhabited by the taxpayer during each year that it is claimed as a principal residence. It is interesting to note that a seasonal residence (such as a summer cottage or ski cabin) which is primarily for personal use may qualify as ordinarily inhabited. Paragraph 9 of the above noted Interpretation Bulletin gives Revenue Canada's position on this matter. Note that the ordinarily inhabited test extends to situations where the home is occupied solely by a spouse or former spouse. This rule will give some tax relief in situations involving separation or divorce.

Designated as a Principal Residence. Revenue Canada has provided a form for this (T2091) which should be filed with the tax return for the year of disposal of a principal residence. However, if none of the gain will be taxable, the tax authorities will not insist that this form be filed.

The above factors are the basic tests of a principal residence. If the property qualifies, a special formula is used to calculate the amount of the capital gain which is exempt from tax. In most cases, this will be the entire gain.

What Special Alternatives Exist for Farmers? The Income Tax Act allows a farmer two ways in which to calculate the exempt gain when farm property is disposed of.

Under the first method, the farm can be hypothetically divided into two portions. One part will be the farm house plus one or more acres which "contribute to its use and enjoyment". The other part will be the rest of the farm property. A reasonable allocation of the sale proceeds must then be made between the two parts.

The same allocation must be made for the "adjusted cost base" (in most cases the December 31, 1971 value of the farm or original cost if it was bought after that date, plus improvements). Once this is done, the capital gain on the principal residence portion and the capital gain on the rest of the farm can be calculated. The principal residence gain will most likely be exempt from tax. The gain on the rest of the farmland will be treated in the same manner as any other capital gain which is subject to tax.

Under the second method, the farmer will not have to segregate the principal residence portion of the property in the calculations. Instead, to arrive at the capital gain, the selling expenses and the adjusted cost-base are subtracted from the entire proceeds of disposition. The capital gain can be reduced by an amount equal to $1,000 plus $1,000 for every year that the house has been the farmer's principal residence since December 31, 1971. Part years count as full years for this purpose. If the farmer owned a farm from November 1970 to January 1989, for example, the exemption would be $1,000 plus 18 x $1,000 = $18,000. To take advantage of this second method, a farmer must file a special letter with the tax return which sets out certain information concerning the property.

The best method to use will depend on the facts in each case, but farmers should at least be aware that both methods exist and that they are entitled to use the one which gives them the larger exemption. During a period of falling real estate values, the second method may produce beneficial results which are available only to farmers.

Can a Husband and Wife Each Have a Property Which is a Principal Residence? Prior to January 1, 1982, it was possible for a husband and wife to each designate a home as a principal residence and have any capital gain on the house exempt from tax.

After December 31, 1981, a family unit may designate only one property as a principal residence for any year after 1981. A family unit will normally consist of a husband, wife and children under 18. Where a family unit owned

two properties on December 31, 1981, any capital gains on the properties to that point may be exempt from tax, but the gains on only one property will be exempt after that date. The rules in this area are somewhat complex, and it is suggested anyone in this position consult a tax advisor.

What if Farm Home Expenses are Claimed? Where a home, located on a farm, is used to earn farm income, the income tax authorities allow a farmer to claim, as a business expense, a certain portion of costs incurred in connection with the home. A "reasonable portion" of the cost of light, power, heat, repairs, taxes, telephone, etc. and fire insurance will be allowed as business expenses to be deducted against farm income. A general rule of thumb is 25% of the total costs mentioned above. Effective in 1988, these expenses will only be deductible provided that the home office is used exclusively on a regular and continuous basis to earn business income. Also, the office must either be the taxpayer's principal place of business or used by the individual on a regular basis for meeting clients or customers. In the event that your farm is in a loss position, you will be denied these office expenses as the deduction will be limited to the income from the farming operation. However, any farm office expense disallowed as a result of this limitation may be carried forward and claimed against farm income in a subsequent year. If a house on the farm is used solely for the purpose of providing lodging to hired help, the full amount of expenses incurred in connection with the house will be deductible if they are paid by the farmer.

In addition to the out-of-pocket expenses mentioned above, capital cost allowance may also be claimed on the farm house. The capital cost allowance schedule (Form T2041) shows how this claim is made for the straight-line method. For the declining balance method, the claim would be made in a similar way, with the portion of the cost of the home (excluding land) which represents the part of the home used for farm business purposes having to be calculated. Capital cost allowance would then be taken on this amount in the same manner as on any other farm building.

It is important to remember that, when a farm home is disposed of, deductions for capital cost allowance in prior years may result in some income tax. The reason for this is that recapture of capital cost allowance may arise if the proceeds of the sale which relate to the business-use portion of the farm home exceed the undepreciated balance of that portion of the home for tax purposes. This will only happen if the home was being written off on the declining balance method. Since recapture never occurs under the straight-line method, farmers who owned their homes at December 31, 1971 and were using the straight-line method may continue to use this method under the new tax law. They would be wise to do so if capital cost allowance is to be claimed.

As mentioned earlier, for homes (and any other depreciable assets) purchased after December 31, 1971, only the declining balance method is available. As a result, a potential recapture of capital cost allowance, and income taxes therein, may arise in the future as a result of claims taken in prior years.

What Happens to the Principal Residence Exemption if a Farm Home is Left in Trust to a Spouse on Death? This is mentioned because it is common for a family home to be left in trust to a spouse for the balance of the spouse's lifetime and then to the children when the spouse dies. No capital gain arises at the time the property rolls over to a trust created for the spouse, providing the trust meets certain conditions set out in the Income Tax Act. Even if a gain did arise at this time, it would normally be fully exempt from tax as a gain from the disposal of a principal residence.

What is of concern is a situation where a home is owned by a trust, is occupied by the surviving spouse for a period of years, and increases in value until the time it is either sold or the surviving spouse dies. One of the principal residence tests — ownership — is missing since the trust owns the property. In this case, the Income Tax Act provides a special rule which

allows the trust to designate the property as a principal residence. The entire capital gain arising since December 31, 1971 may be exempted from tax, providing the proper designation is made.

Assume a farmer owned his home from 1972 to his death in 1980, during which time it increased in value by $27,000. The home was transferred to a spouse trust for his widow who lived in the home until her death in 1987, during which an additional increase in value of $30,000 occurred. The income tax rules are designed in such a way that both of these increases in value will be tax exempt. It is important, however, that the appropriate designation of the property as a principal residence be made by the trust when the second disposition occurs. If this designation is not made, exemption of the gain under the principal residence rules could be denied.

Can a Farm Corporation or a Farm Partnership Own the Family Home? Farm corporations and partnerships are not allowed to own a principal residence which is afforded tax exempt status. If the farm is incorporated or is owned by a partnership, the house and parcel of adjacent land should be separated from the corporation or partnership and thereby have it qualify as a principal residence.

Depending on the rules in a particular area, a subdivision of the principal residence from the corporation or partnership could alter the classification of the farm home from farmland to an acreage for tax assessment. Additionally, this transfer could create a current taxable gain in the corporation or partnership and the loss of future income deductions which relate to the farm home. In each farm situation, a separate determination should be made to see if any benefit will be gained by this creation of a principal residence.

Can a Father and Son Each Have a Principal Residence on the Farm? There are many situations today where fathers and sons are jointly farming the same farm on which each has a residence. In determining whether or not two principal residences can be designated, the concept of ownership is important. Each may designate a principal residence if they both own the farm property as tenants in common or joint tenants. Only one principal residence may be designated if either the father or son owns the farm. It should be remembered that the more years the home is designated as a principal residence after 1971, the less the capital gain will be when the farm is sold.

See the chapter headed "The $500,000 Lifetime Gains Exemption".

Income Averaging

What is it and What Purpose Does it Serve?

Income averaging is a term applied to any system which evens out income over a period of years. It is beneficial to taxpayers to report even levels of income from year to year because individual tax rates are based on a progressive scale. The more income reported in any one year, the greater the percentage that is paid in taxes. A resident of Alberta who had taxable income of $10,000 in 1988 for example, paid tax at a rate of 30% on the last dollar of income (called the marginal rate of tax). If taxable income increased to $30,000 in 1988 the marginal rate of tax would rise to 39%. The federal government has recognized that farmers, in particular, could be penalized by this system purely because of the cyclical nature of the agriculture industry, where incomes can often fluctuate considerably from one year to the next. As a result, for many years farmers have been able to average their income under special rules designed to give tax relief. A table of federal tax rates and provincial tax rates is contained in the Appendix.

What Income Averaging Tools Are Available?

Numerous strategies may be employed in controlling wide fluctuations in income from year to year. The ones to be covered in this chapter are:

- five-year block averaging;
- forward averaging;
- livestock inventory provision.

Five-Year Block Averaging

This method of averaging has been available to farmers for a number of years. It has largely continued unchanged, except that it is no longer available to a corporation as was the case prior to 1972. It can be used by all individuals whose **chief source of income** (see Farm Losses, page 53), was farming throughout the five-year period. The Farmer's Income Tax Guide gives an excellent summary and illustration of five-year block averaging.

The election to use the five-year block averaging provision is made when the income tax return is filed for that year. However, the previous four years' returns **must have been filed on time**, and the chief source of income must have been farming **for each of the five years** included in the averaging period. The "previous four years" mentioned above includes the most recent four years in the previous six years for which a return has been filed. Form T2011 (which is included in the **Farmer's Income Tax Guide**) must be completed and filed with the return. Note that a tax return for any nil income year that was not filed in the past, can still be technically filed on time if it is sent in during the year the block averaging calculation is used. As well, in making the calculations for the five-year block averaging, only losses incurred in the averaging period may be deducted in computing the five-year gross income to be averaged. Non-capital losses incurred outside the block averaging period but applied against certain years in the block must be withdrawn from the block period.

The rules relating to block averaging provide that no year may be included in a five-year block average, if an amount was added or deducted from income under the forward averaging provisions.

Some of the benefits of using a five-year block average are as follows:

- When income varies from year to year within a five year period, the block average may reduce the tax payable in the year of averaging and/or result in a tax refund.
- A farmer is allowed to pick up any business loss and/or unclaimed personal exemptions and non-refundable tax credits from the block period and apply these against years with positive net income.

- Abnormally large increases in the income stream, such as a sale of inventory, recaptured capital cost allowance and the taxable portion of any capital gain, etc., can be included in a block average.
- By combining the five-year block average with the livestock inventory provision (LIP), livestock producers, under certain circumstances, may elect to artificially inflate their net farm income in the year of averaging. This strategy enables all eligible farm losses, personal exemptions and tax credits to be recouped. By artificially inflating the income in the year of averaging, the increase in tax payable may be minimal, as the additional income is spread over a five-year period. This results in a large carryover into the following year and, therefore, can be very effective if a very high income is expected in the year succeeding the block average period.

The block averaging provision is currently being phased out. An election can only be filed where the earliest of the previous four years used in the election ended before 1988. In most cases, 1991 will be the last year to block average.

Forward Averaging

The forward averaging provisions enabled a taxpayer to defer the recognition of income from any source to the extent that it was in excess of a calculated threshold amount. This threshold was equal to 110% of the taxpayer's inflation adjusted average net income for the previous three years.

Effective for 1988 and subsequent taxation years, forward averaging will no longer be available. Amounts averaged in years previous to 1988 may be drawn down and included in income in any year before 1998.

Livestock Inventory Provision

The livestock inventory provision has been available to individual and corporate farm taxpayers since 1972. The provision, in most cases, more than makes up for the loss of the Basic Herd option as it is a more flexible method of averaging income from year to year. The term livestock under these provisions applies to all species of livestock on the farm kept for business purposes (e.g., cattle, hogs, sheep, goats, horses, poultry, bees, fur bearing animals, etc.).

This provision allows farmers to include in their farming income for the year any amount up to the fair market value of their livestock (other than basic herd animals) owned at the end of the year. In the following year, the farmer is required to reduce his income by the amount of this livestock inventory provision and accordingly set up a new or current year livestock inventory provision. It is, however, only available to farmers who have inventories of livestock and file on the cash basis.

Consider the following reasons for using the livestock inventory provision:

- If a farmer who is building up a herd over a period of years incurs tax losses for more than ten years, the opportunity of deducting these losses against income will be lost. By using the method of increasing the tax value of livestock inventory to reduce each current year's loss, a farmer can lessen this restriction of tax losses.
- Another important consideration for arranging income in this manner concerns the utilization of tax credits. Assume a farmer has non-refundable personal tax credits totalling $2,000 available. If these credits are not utilized by offsetting them against current year's income, then the opportunity to claim them may be lost. Non-refundable personal tax credits can never be carried forward to the next year nor can they be used to increase a current loss.
- Under the Canada Pension Plan, persons who are self-employed (including farmers) must contribute up to a maximum of $956 (1988) for the year. This maximum contribution level is based on $26,500 of self-employed earnings in the year. If less than $26,500 is earned (1988), the contribution would be correspondingly less. A farmer who reports a loss does not have to make any contributions. The benefits a person (or dependants) will eventually receive from

our national pension scheme are based strictly on the amount of contributions which a person has made. For this reason, it may be advantageous for a farmer to report net self-employment earnings each year at **least equal to the CPP earnings maximum.** This will ensure the maximum benefit when a person starts to collect. In planning the amount of income, the CPP earnings maximum should always be checked. This information can be found in the income tax form or T1 guide.

- The comments made for Canada Pension Plan earnings also apply in situations where a farmer may wish to purchase a registered retirement savings plan.
- A corporation cannot block average, but may use the Livestock Inventory Provision to its advantage when there are unused losses which must be claimed. As well, a corporation may use the provision to smooth out income to keep under the $200,000 annual limit, in order to qualify for the small business tax rate.
- In circumstances where the farmer has other sources of income and wishes to block average, he could bring enough into income under the livestock inventory provision rules to ensure his chief source of income is from farming, thus enabling him/her to qualify for the block average provisions.

We have mentioned six reasons why a farmer who has inventories of livestock might wish to adjust the level of income reported by taking in a portion of the value of year-end inventory. If tax returns for prior years have been filed without using this provision, it may be worthwhile to approach the tax authorities to ask for a revision of previous years to claim personal exemptions and eliminate losses. Legally, they don't have to allow the changes, but it may be worth a try.

The amount of capital cost allowance which a farmer takes for the year is also flexible (within limits) and can also be used to adjust income to a desired level. This strategy is available to all taxpayers, not only to farmers, whether they are on the cash basis or accrual basis of reporting income.

However, the farmer who is on the cash basis and who raises livestock has the most flexible situation of all. Consider the situation where a farmer has a zero net farm income before CCA and a balance of $100,000 in class 10. The farmer could either a) claim no CCA, or b) claim $30,000 of CCA, creating a $30,000 loss, and add $30,000 under the livestock inventory provision. Either way, the net income for the year is zero. If the farmer is expecting a high net income in the following year, the following deductions would be available under each of the above mentioned alternatives:

Year 2

a) $30,000 of CCA or

b) $21,000 of CCA (30% of the $70,000 UCC)
and $30,000 Livestock Inventory Expense
$51,000

By using the flexibility of the livestock inventory provision, the farmer is able to plan to minimize taxes. If a farmer doesn't make use of available strategies, the result may be more taxes at higher rates than necessary.

Tax Reform

Effective for taxation years commencing after 1988, tax reform extends the livestock inventory election to ***all*** *farm inventory. The maximum value of this new flexible inventory election will be limited to the fair market value of all inventory less the current year Mandatory Inventory Adjustment. This Mandatory Inventory Adjustment is explained further in the chapter dealing with Farm Losses.*

Property Transfers

The transfer of farm property is a subject of major importance as it often can be accomplished through proper tax planning without the incidence of current income tax. This type of transfer can be accomplished through an intergenerational farm rollover and through the application of the $500,000 capital gains exemption. This chapter will look at some of the tax consequences of selling a farm, changing location of the operation, as well as the family farm rollover provisions and the application of the $500,000 capital gains exemption.

Selling the Farm

A person in the business of farming may decide, for various reasons, to sell the farming operation. The sale of a farm is a complex transaction dealing with many factors which should be taken into account before a decision is made. This discussion is concerned with only the tax implications of such a sale although there will also be numerous non-tax considerations. The more knowledgeable a person is before a sale, the better able that person is to make use of any tax advantages which are available, while at the same time avoiding any unexpected tax costs. All persons who contemplate the sale of their farm are urged to seek sound tax and other professional advice in advance of such a transaction.

The tax consequences of the sale of a farm can be summarized by answering the following four questions. These questions may appear quite simple, however, a closer examination of some of the simple questions reveals tax problems which might occur.

What is Being Sold? The details concerning all the property which is being disposed of must be considered as follows:

- Are there any government rights or licences (such as a milk quota)? If so, special rules exist as to the tax treatment of the proceeds from the sale of the rights or licences.
- How have livestock been treated for income tax purposes? If a farmer had been using a basic herd and has not yet disposed of these animals, the tax treatment will differ from that of a farmer who did not have a basic herd at the time of sale.
- How has the farmer treated depreciable property (buildings, vehicles, equipment, etc.) for tax purposes? When the assets are sold, the tax treatment of property which was written off on the straight-line basis will be different from the treatment of property handled on the declining balance basis.
- Does the sale of assets include property that was a principal residence of the farmer? If so, allocations of proceeds which relate to the principal residence must be made and a decision taken as to which of two basic methods will be followed in calculating the exempt portion of any capital gain. Care should be taken that the exemption for principal residence is used to best advantage especially if more than one residence is owned.
- Are there any inventories of crops or accounts receivable which have not been previously reported in income? If so, the value of such crop inventories or accounts receivable will be brought into income at the time of sale. Special advantages may be available where an unharvested crop is sold as part of the value of the land.

The foregoing list is by no means an exhaustive summary of the types of assets which may be sold or the tax treatment attached to them, but merely an attempt to highlight the complexity of the tax considerations which are revealed under the more general question of "what is being sold?"

To Whom is it Being Sold? The question of "to whom" is also deceiving. As will be discussed later, if the sale is made on a non-arm's length basis (to a spouse for example), special tax rules apply. A sale to the farmer's children,

grandchildren or great-grandchildren will involve different rules again.

If assets are sold to a corporation or partnership of which the farmer is either a shareholder or partner, there is, once again, a different set of rules applicable. Even the sale to a third party may not be free from complications, particularly if the farmer who is selling the property decides to leave the country on retirement. If the farmer ceases to be a resident of Canada, certain reserves which may have been claimed against the unrealized portion of a capital gain will no longer be available. As well, the farmer will not be allowed a capital gain exemption if he is not a resident of Canada. Also, by leaving Canada, a responsibility will be placed on the person who bought the farm to withhold tax (the rate will vary from 15% - 25% depending on the country in which the recipient lives) on interest payments made under the financing arrangements. This amount must then be remitted to the Canadian tax authorities. If property is being sold to someone who is not a resident of Canada, there may be special rules to be followed under a provincial land ownership act.

An explanation of any provincial legislation is available from your local district agriculturist's office. In addition, federal legislation such as the Investment Canada Act, may apply.

For How Much Is It Being Sold? In answering this question one must consider several important factors. First of all, if various assets are sold as a package, the proceeds from the sale must be allocated to each asset group on a reasonable basis. If possible, it is desirable to specify in the sale agreement the sale proceeds applicable to each asset being sold. In addition, if the property was owned at December 31, 1971, a V-day value must be determined for each asset owned. Thirdly, the historical cost of each asset must be determined wherever possible. This type of documentation is necessary to determine the amounts of capital gains and losses, income gains and losses, recapture of capital cost allowance or terminal losses which arise as a result of the sale. The allocation of the sale proceeds to the various assets will have a direct effect on the amount of income tax which must be paid. The same allocations which apply to the purchaser must also apply to the vendor.

How Will Payment be Made? This question does not appear to involve tax considerations until one considers the hardship which can arise if a person is subject to tax on income before actually receiving the cash. As discussed in the capital gains section, there are provisions in the Income Tax Act which allow a deferral of the realized taxable capital gains where the proceeds will be collected over a period of years. These rules, however, also encourage an instalment period which might be shorter than would otherwise have been negotiated.

The tax consequences to consider on the sale of a farm are numerous. They are also complex, and this complexity can work both to the advantage and to the disadvantage of the farmer. For this reason, tax advice should be sought before an offer to purchase is signed to ensure that no hardship is caused to the farmer and that use is made of every tax advantage available. For many farmers, the value realized when a farm is sold represents the financial accumulation of a lifetime. It is therefore important the maximum amount of after tax proceeds be realized.

Exchange Of Property – Replacement Property Provision

Voluntary Exchange. Effective March 31, 1977, the tax rules were changed to allow a tax-deferred rollover of certain business assets if they are replaced by similar business assets by the end of the taxation year immediately following the year of disposal. To qualify for this rollover:

- the assets must be land and/or buildings used in a business immediately before the disposition;
- the replacement asset must be purchased before the end of the first taxation year following the disposition of the original asset;

- a letter of election (notification of intent) must be filed in the tax return for the year the replacement property is acquired;
- the replacement asset must be used in the same or similar business as the original asset; and
- if the owner was not a Canadian resident, the property must be taxable Canadian property.

Farmland that is being sharecropped would not qualify under these rules, nor would rented property unless the owner was in the rental business. The reason for this restriction is that the rules require that the asset be used in a business. Receiving rent via a cash rent or crop share would not qualify as a business and thus the replacement property provision is foregone.

Where a replacement property is not acquired until the following taxation year, any recaptured CCA or taxable capital gain from the sale of the original business assets must be reported, and tax paid, in the year of sale. When the replacement property is purchased (within the time limits set above), and the relevant election is made, the tax return for the year of sale will then be reassessed to determine the amount of refund. An appropriate planning strategy would be to arrange for the sale and purchase of properties within the same taxation year.

It is also possible to buy the replacement property before selling the original property. One must still make the required election in the year of purchasing the replacement property but there is no time restriction for selling the property to be replaced. If a sale of property is contemplated in the future, but new property is being purchased this year, the replacement property election should be considered in order to take advantage of this tax deferral at a later date.

The following example illustrates how the replacement property rules will defer a capital gain:

Assume a farmer acquired a section of land in 1972 at a cost of $160 per acre. The aggregate purchase price of $102,400 was allocated between land and buildings as follows:

Land	$ 68,300
Farm Buildings (barn, granary, etc.)	21,300
House	12,800
	$102,400

In January, 1988, the farm sold for $600 per acre. The proceeds of the sale, fully paid at the time of sale, are allocated as follows:

Land	$312,000
Farm buildings	48,000
House	24,000
	$384,000

The undepreciated capital cost of the farm buildings immediately prior to the sale was $9,000. Without the deferral provisions, the farmer would realize capital gains and recaptured capital cost allowance on the sale as follows:

CAPITAL GAINS

Land Proceeds	$312,000
Adjusted Cost Base	68,300
Capital Gain	$243,700
Farm Buildings Proceeds	$ 48,000
Cost	21,300
Capital Gain	$ 26,700

RECAPTURED CCA

Farm Buildings Cost	$ 21,300
Undepreciated Capital Cost	9,000
Recapture	$ 12,300

Total Capital gains and recapture would be:

TAXABLE CAPITAL GAINS

Land (2/3 x $243,700) =	$162,466	
Farm Buildings (2/3 x $26,700) =	17,800	180,266
Recapture		12,300
TOTAL		$192,566

The farmer would realize $192,566 of income from taxable capital gains and recaptured CCA from the sale of the farm. The gain on the house has been excluded because it was treated as a

principal residence. However, in March, 1989, a replacement farm was purchased at a cost of $625 per acre. The total purchase price is allocated as follows:

Land	$321,000
Farm Buildings	60,000
House	19,000
	$400,000

By electing to defer the capital gain and recaptured capital cost allowance under the replacement property provisions, the farmer would adjust the cost, for tax purposes, of the new farm assets as follows:

LAND	
Actual Cost	$321,000
Less: Capital Gain deferred on sale of former land	243,700
Equals: Cost Base for Tax Purposes	$ 77,300
FARM BUILDINGS	
Actual Cost	$ 60,000
Less: Capital Gain deferred on sale of former buildings	$ 26,700
Equals: Capital Cost of Replacement Building	$ 33,300
Less: Recapture of CCA deferred on sale of former building	12,300
Equals: Undepreciated Capital Cost	$ 21,000

The above calculations or adjustments show how capital gains and recapture are deferred. These adjusted values will be used in calculating capital gains and recapture on the sale of the farm in the future.

To further assist in understanding the amount of gain which will be deferred in selling one property and purchasing another, the following table has been prepared:

Cost of Replacement Property	Amount of Capital Gains Deferral
Equal to, or greater than the proceeds from the sale of the former property	Full Deferral
Less than proceeds, but greater than the adjusted cost base of the former property	Partial Deferral
Equal to, or less than the adjusted cost base of former property	No Deferral

In summary, when a farmer is looking at the relocation of a farm business, the following questions should be considered:

- Will the intended use of the replacement property be the same or similar as that for which the former property was used?
- Is the present property being used for the purpose of earning income from a business? **(Not to include land and buildings rented to a child.)**
- If the present property is disposed of, when does the time limit for purchase of replacement property expire?
- What is the value or cost of the replacement property compared to the value of the property being sold?
- Will it be possible to defer all or only a part of the gain from the sale of property and purchase of replacement property?

Answers to these questions should define the situation. Also, professional assistance should be obtained to ensure that the transactions are executed in an appropriate manner.

Involuntary Dispositions. As is the case with the voluntary exchange of property discussed above, all or part of any gain on the disposition of a capital property which results from an involuntary disposition of that property may be deferred. All or part of the recapture of capital cost allowance on the disposition of depreciable property may also be deferred. An involuntary

disposition generally refers to property that has been expropriated, lost or destroyed.

The replacement property provisions for involuntary dispositions are similar to the rules which apply for voluntary dispositions, with two important exceptions: 1) The time limit for replacing such property is the end of the second taxation year following the year in which the property was expropriated. 2) The provisions apply to most capital and depreciable property.

It is important to note that, when property is expropriated, lost or destroyed, payment is often not received quickly. The most common example of this occurs when a building is destroyed by fire and the insurance proceeds are received at a later date. Under this type of situation the taxpayer will have been deemed to have received fair market value for his buildings which will result in the same tax implications as if the building was sold. However, when the insurance proceeds are received and reinvested in a new building, then the replacement property rules will apply. The deemed capital gain and recapture is then subtracted from the subsequent new buildings cost perhaps leaving the taxpayer with no tax liability. The tax authorities also recognize the time differential between the destruction of property and the insurance proceeds received and thus the year of disposition for tax purposes will generally be extended to the taxation year in which an amount becomes receivable in respect of that property. Again, to ensure that you keep the flexibility of this tax provision, you should seek tax advice for each specific situation.

Rollovers

A rollover occurs when eligible property is transferred between two parties, and the recognition of a capital gain or loss, or recaptured depreciation is deferred for income tax purposes. The farm rollover was a special concession to the farming community when introduced in the federal government's 1973 budget. It is one of the most significant tax planning considerations for owners of family farms. It is important to remember that the rollover is a tax deferral; when the property is eventually disposed of it will be subject to tax.

A rollover can occur where:

- any capital property is transferred from an individual to a spouse or to a spouse trust;
- farmland and depreciable property, used in the business of farming, are transferred from an individual to a child;
- any property is transferred to a partnership;
- any property other than land inventory[1] or real property owned by a nonresident, is transferred to a corporation;
- a share in a family farm corporation or an interest in a family farm partnership is transferred to a child;
- a share in a small business corporation is transferred to a child;
- eligible capital property (i.e., quota) is transferred to a child;
- any property received by a child on a rollover is transferred to a parent as a result of the child's death.

Transfer of Property to a Spouse. Simply stated, this rule provides that, when property is transferred to a spouse, taxable capital gains and recaptured capital cost allowance may be deferred until a later date.

The transfer of capital property to a spouse is deemed, for tax purposes, to take place at the transferor's adjusted cost base of the property. Depreciable property is transferred at its undepreciated capital cost. As a result of this deemed transfer, the tax liability will be deferred until the property is sold to a third party or until the death of the spouse, at which time the

[1]Land inventory refers to land which, when sold, gives rise to ordinary business income rather than a capital gain; e.g., a farmer who subdivides several pieces of land may be deemed to be in the business of buying and selling land. The land, therefore, will be inventory to him.

taxable capital gains and recaptured capital cost allowance must be reported.

The deferral of tax will apply whether property is transferred to a spouse during the transferor's lifetime or is left by outright bequest or in trust to a spouse on the transferor's death. If a trust is used certain requirements must be met, and these should be carefully considered at the time a person's will is drafted authorizing the trust. The lawyer or accountant should be aware of these requirements and can advise accordingly.

The purpose of this special rule is to recognize, in a limited way, the sense of the community of property which normally exists between husband and wife. For most properties transferred between a husband and wife, tax will not be payable until the property passes on to the next generation, on the death of the surviving spouse. In the case of the family farm, however, not only is it possible to obtain a rollover on a transfer to a spouse, but also to obtain similar treatment on a transfer to the next generation.

Although the general rules provide for a transfer between spouses at cost, the taxpayers might elect to transfer the property at fair market value and thus opt out of the spousal rollover provision. This provision may be beneficial in certain circumstances and is discussed in greater detail in the chapter dealing with the $500,000 capital gains exemption.

Transfer of Property to Parent from Child – After 1983. To accommodate cases where a child dies after having property rolled over to them from a parent, an election is now available for that property to be rolled back to a parent. This election also allows for the transfer back of the property to occur at any value between the child's cost and fair market value.

Transfer of Property to a Child. A rollover can occur when **farmland, eligible capital property and depreciable property are transferred to a child**. The transfer may be a sale, gift or bequest. To transfer a family farm to your child without triggering income tax on capital gains and recaptured capital cost allowance, the following five requirements must be met:

1. Used in the Business of Farming. In order to be entitled to the rollover, the property must be used, immediately before the transfer, by the taxpayer, the spouse or a child in the business of farming. The transfer may take place during the farmer's lifetime or at the time of his death. Note that there is no rule that requires the children to carry on the farming business for any specified period of time after the transfer. Note also that the owner of the property himself does not necessarily have to have been the individual who was in the "business of farming". In fact the property could be leased to a family farm corporation or family farm partnership of the taxpayer, the spouse or a child and the property would still qualify. However, if a farm is rented or leased to an arm's length third party, the rollover rule will not apply if the owner should die or transfer the property while the lease is in effect. It is important to note however, that if a farm is rented or leased to an arms' length third party, that the rollover rule will apply if the property is left to the children through a spousal trust.

Under these circumstances, as long as the property is used in the business of farming then the property may, upon the death of a spouse, transfer from the spousal trust to the taxpayer's children and qualify for the rollover. The purpose of this exception was to allow widows to retain control of their land and not require these spouses to maintain an active farming status.

2. Transferred to a Child. The farm property must be transferred to a child of the farmer. For purposes of these provisions, the definition of a child includes a grandchild or great grandchild. An adopted child, step-child or spouse of a child are also included. For transfers after 1983 the definition of child also includes a person who, before age 19, was wholly dependent upon and under the custody and control of the taxpayer. The person who receives the property must also be a resident of Canada at the time of transfer.

The extended definition of a child makes it possible for anyone, whether legally adopted or not, to qualify as a child. An example of this would be where a farmer, after the death of his brother and sister-in-law, takes in a nephew at

the age of 17. The nephew was wholly dependent upon his uncle and remained under his custody and control until the age of 22. Since the nephew will qualify as a child, the uncle can transfer eligible property to the nephew on a rollover basis.

3. Owned by the Farmer. The property must be owned by the farmer. It could, however, be held under joint ownership by the farmer and spouse or children. Both forms of co-ownership, that is joint-tenancy and tenancy-in-common, would qualify.

If two individuals owned a farm property as joint tenants, they may have difficulty transferring their interests to their children unless they rearrange the ownership of the property before transfer. Upon death, the interest in the land is automatically transferred to the remaining tenant under joint tenancy. The deceased individual cannot transfer, via his will, his interest in this land because under law that land has transferred to the remaining tenant immediately before death. Owing to the potential complexity of this reorganization, qualified advice should be sought.

4. Canadian Property Only. The property must be land or depreciable property which is situated in Canada. Only depreciable property on the declining balance method will qualify for the rollover to a child. Straight-line depreciable property must be transferred at its fair market value. Once straight-line property has been transferred to a child, it must be depreciated using the declining balance method. Where the transfer occurs during the lifetime of the farmer, eligible capital property, such as dairy quotas related to a business in Canada will also qualify for the rollover.

5. Transfer of Ownership within Thirty-Six Months. In the case of transfers from an estate, the ownership of the property must have been transferred to the beneficiary of the estate within thirty-six months of death. In cases where this time limit may be difficult to meet a longer period may be allowed if special circumstances warrant it.

All five basic requirements must be met in order to transfer the family farm property, either during the farmer's lifetime or upon his death, without triggering income tax. It is conceivable that such tax could be postponed indefinitely if the farm continues to be passed on from one generation to the next. In the past there was no rollover where property was transferred from a child to a parent as a result of the child's death. This rollover has now been added with respect to transfers after 1983. In addition to the basic requirements discussed above, the property must have been received from a parent as a rollover and the subsequent transfer back to a parent must have been as a consequence of the child's death.

Where a farm property transfer occurs prior to the farmer's death, the two parties can select any amount between the tax value (ACB) and fair market value as the disposal proceeds. It is important to note however, that actual cash consideration must exchange hands in order for the transfer price to exceed the tax value. Many farmers believe, that simply electing a value that exceeds the tax base can be used in an inter vivos (alive) transfer between two parties. This is not the case. Strategies that accomplish a transfer for amounts that exceed the tax value are discussed in greater detail in the chapter dealing with the $500,000 capital gains exemption.

Where farm property is being transferred as a result of a farmer's death, the executor of the estate can elect as the property's transfer value, any amount between the tax value to the deceased farmer and fair market value, as proceeds to a child. If the property is being left to a spouse, the executor of the estate can either elect the transfer value at the tax value or the Fair Market Value, but no value in between. The executor can, therefore, create an amount of income to utilize any loss carry-forward, investment tax credit carryover, or the $500,000 capital gains exemption by choosing the transfer value of the farm property to a child. Remember that in testamentary transfers no actual cash consideration needs to exchange hands as the

executor can simply elect a value greater than the tax base.

As in all situations, should the child or one of the heirs eventually transfer or sell the property outside the family, the transfer will occur at the negotiated price. At this point, a capital gain or loss will be calculated from the original cost base. Remember that the rollover provision only **defers** income tax on capital gains or recaptured depreciation.

Having looked at the rollover of farm property to a spouse or to children, we should also consider another important aspect of the rollover provisions. In drafting a will, a farmer may wish to leave a life interest in the farm property in trust for a surviving spouse with the children receiving the farm when the surviving spouse dies. This is more fully discussed in the section dealing with Estate Planning.

Transfer of Property to a Partnership. The rollover provisions also apply when farm property is transferred to a partnership, providing certain formalities are observed. By using these provisions, it is possible for a person entering into a partnership arrangement to contribute property to the partnership without triggering tax. Owing to the complexities involved in transferring farm property to a partnership, competent professional advice should be sought to avoid the premature realization of a taxable capital gain or recaptured capital cost allowance. On the other hand, a taxpayer may wish to trigger a taxable capital gain when transferring property to a partnership in order to utilize part or all of an individual's $500,000 capital gains exemption.

Transfer of Property to a Corporation. Where a farmer wishes to incorporate the farm business, business assets may be transferred to a corporation without incurring an immediate tax cost. The rollover allows the tax, which would otherwise arise, to be deferred either in whole or in part. The rules require, in part, that, in return for property transferred to the corporation, the taxpayer receive some shares in the corporation. As this again is a potentially complex transaction, professional advice should be sought in deciding at what value your assets should be transferred, depending once again upon your individual situation regarding the $500,000 capital gains exemption.

Transfer of Shares in the Family Farm Corporation and of an Interest in a Family Farm Partnership. The Income Tax Act allows the transfer of an interest in a family farm partnership and of shares in a family farm corporation from a farmer to a child on a tax deferred basis. To understand these provisions, it is important to first determine what is meant by a family farm corporation and a family farm partnership.

A share of the Capital Stock of a Family Farm Corporation means a share of the capital stock of a corporation that, at the time, carried on the business of farming in Canada in which it used all or substantially all of its property and in which that person, spouse or child was actively engaged. This definition has been expanded to include a corporation which holds shares or debt of a family farm corporation.

Interest in a Family Farm Partnership means an interest in a partnership that, at that time carried on the business of farming in Canada in which it used all or substantially all of its property and in which that person, spouse or child was actively engaged.

Each definition states that the entity must use "all or substantially all of its property" in farming. Revenue Canada's interpretation of the word "substantially" is normally 90% or greater. Therefore, at least 90% of the entity's property must be used in farming. Revenue Canada has stated that an asset is considered to be used in farming if it is used more than 50% of the time in farming. Therefore, if a truck is used 60% of the time in farming and 40% in some other non-farming operation, it will count towards the 90% test.

Additionally, this rollover is subject to the following rules:

- Immediately before the transfer, the share must qualify as a share of a family farm corporation or the interest must qualify as an interest in a family farm partnership.

- The property is transferred to a child.
- The child must be resident in Canada immediately before the transfer.
- The transfer of ownership must occur within thirty-six months of death.

As is the case with the rollover of farm property, a farmer may transfer the shares in a family farm corporation or an interest in a family farm partnership at any value between the properties' adjusted cost base and fair market value provided consideration is given. This allows some flexibility in tax planning.

Other Federal Income Tax Consequences to Consider

Under certain circumstances, income and capital gains which arise from any property transferred to certain family members will be taxed in the hands of the transferor. These special income tax rules are known as the **attribution rules**. The Income tax authorities have explained these rules in detail in Interpretation Bulletins IT-510 and IT-511, but some of the more basic points will be discussed here:

Income from Property which is Transferred to A Spouse or Any Person Under the Age of 18. This income is to be reported on the tax return of the person transferring the property, not the spouse's or the minor child's. In the case of a spouse, this rule will apply as long as the transferor remains alive, legally married and resident in Canada. In the case of children, the rule ceases to apply in the year the child reaches the age of eighteen. However, if the property is used in a business, such as a farming business, these rules will not apply regardless of the child's age.

Capital gains on Property Transferred to A Spouse or a Minor Child. The same principle that applies to the income from property transferred to a spouse also applies to capital gains on the property. Capital gains on property transferred to minor children, on the other hand, are not attributed back to the person who formerly owned the property. There is one exception to that rule:

Farm Property Transferred to Minor Children. This exception, referred to above, is of considerable interest to farmers. If the farm property is transferred to a minor child, and the child sells or disposes of it before the year in which the child reaches age 18, any capital gains on the property will be taxed in the hands of the former owner. Although such a situation is rare, it is something of which a farmer should be aware. The rule was necessary to prevent a perceived abuse of the law where the sale of the farm to a third party was contemplated in the first instance. For example, if a farmer sold the farm to the child, and then the child sold the farm to a third party, the capital gains and recaptured capital cost allowance would be taxable in the hands of the child at lower rates of tax.

Where money is given to a spouse, any income (i.e., interest) earned on that money will be taxed in the donor's hands, not the spouse's. However, any income which is earned on the above interest will be taxed in the spouse's hands.

Before the May 23, 1985 budget it was possible to make a genuine and properly documented loan to a spouse. In such circumstances the spouse could have invested the funds and earned income without the attribution rules of the Income Tax Act being applied. Such loans are now considered a transfer of property and will result in attribution. For loans outstanding on the budget date, the attribution rules **do** not apply if they **were** repaid by December 31, 1987.

For 1989 and subsequent taxation years, any loans of property to a related individual will result in attribution. The typical situation covered by the new rule is a low interest or no-interest loan made to your adult children and the children invest the funds to earn interest.

This review of the attribution rules is somewhat oversimplified. Reference should be made to the provisions of the law and to Interpretation Bulletins IT-510 and IT-511 to see whether or not they apply to a particular situation. Whenever farmers transfer property to a spouse or to a minor child, they should thoroughly investigate the income tax consequences.

There may be situations where both a husband and wife have separate sources of income and each accumulates savings or investments in his or her own right. In a case where a person has a farming business, for example, and the spouse works off the farm, any income which is derived from the spouse's savings will always remain taxable to the spouse. Since it is usually beneficial, from an income tax point of view, to be able to split income between husband and wife, it is important to be able to substantiate the origin of the funds. If no records are kept, and the spouse has ceased to work, the tax authorities might determine that the funds in question did not come from the spouse's earnings and, therefore, the investment income should not be taxable in the spouse's hands. To avoid this, it is prudent to keep a separate accounting for each spouse's earnings and savings. In that way, the income tax authorities can be readily convinced that income has been reported properly.

Transfers of Farm Inventory

Upon transfers of farm inventory to children, many taxpayers simply "gift" inventory (e.g., cattle) and do not report this transfer on their return. According to the Income Tax Act, inventory does not qualify for the family farm rollover provision and thus a deemed sale has occurred. In other words, the taxpayer will have been deemed to have received fair market value for the inventory transfer while the child will be allowed an offsetting expense. In order to transfer inventory at a reduced tax basis, the following strategies should be considered:

- Actually sell the cattle to a child for debr due over a period of ten years with no interest. This type of debt is commonly termed a producer's note. This will provide a ten year "reserved mechanism" whereby a child will pay one-tenth of the sale proceeds to the parent, resulting in taxable income of only 1/10th and a resulting deduction. If the intent of the parents was to strictly gift the cattle over, the annual payment could be given back to the child as a gift.
- Transfer inventory as payment in kind for labour on the farm. The cattle are sold on the child's tax return with the parents showing a salary deduction but the parents also must report the income on their own tax return. The net effect to both the parents and the child is the same as if a salary were paid directly.
- Inventory can be transferred tax free via a will under a special provision related to Rights or Things. Under this provision inventory can be left to a named beneficiary and that beneficiary will pay tax on the inventory when sold. An important strategy is the combining of a producer's note, as explained above, with the special Rights or Things provision. A taxpayer could sell cattle to his children and through a will forgive that note under the Rights or Things provision. There is no adverse tax consequence on this strategy and the child will now inherit the balance of the cattle with the note being extinguished.

The $500,000 Lifetime Capital Gains Exemption

On May 23, 1985 a new set of rules regarding capital gains was introduced into the Canadian tax system. The intent according to the finance minister, was to "encourage risk taking and investment in small and large businesses and to assist farmers by providing a cumulative tax exemption for capital gains up to a lifetime limit of $500,000". Since the introduction of the capital gains exemption some major changes have taken place whereby the capital gains exemption has been reduced to $100,000 except in respect to the disposition of qualified farm property and shares of Canadian controlled small business corporations. The relevant details of the exemption are as follows:

- The exemption will apply to capital gains net of capital losses realized in a year to a lifetime maximum of $500,000. Although there will be no regular tax on a capital gain qualifying for the exemption, the Alterative Minimum Tax calculations may result in tax on this net gain.
- The exemption will apply to all capital gains realized after 1984 by individuals only. Corporations therefore do not qualify for this exemption. Since the initial introduction of the legislation, ownership has been extended to include a family farm partnership, ownership by certain trusts where the beneficiary is related to the owners of the property from whom the trust acquired the property, spousal trusts and parents.

Property that would qualify for the exemption includes;

- farm land;
- buildings;
- machinery;
- eligible capital property (quotas);
- corporate shares;
- partnership interest.
- In 1988 and 1989 the taxable capital gains that will be sheltered will increase from the previous $250,000 to $333,333 to reflect the increase in the taxable capital gains inclusion rate of one-half to two-thirds. In 1990 the taxable capital gains sheltered through the capital gains exemption will increase to $375,000 to reflect the three-quarter rate of inclusion.
- In order to qualify for this exemption an individual will be required to file an income tax return whether or not tax is payable for the year.
- Capital gains included in income as a result of the capital gains reserve mechanism will qualify for the exemption. For those individuals disposing of qualified farm property a sale could be structured to receive proceeds over time and a they would still have the protection of the $500,000 exemption, whether the gain was all reported in one year or over a number of years using the capital gain reserve mechanism.

This exemption is very important to the farm community as many farmers have experienced a relatively large growth in their asset values. All farmers should acquaint themselves with the rules and regulations of this amendment in order to successfully incorporate the exemption into their estate plan.

It is important to recognize that there are three components that determine whether property qualifies for the exemption or not. These are:

- When was the property acquired?
- Who owns the property?
- Who has used the property?

As a result of the recent legislative changes, there have been amendments to these conditions that will result in a broader application of the exemption.

Farm Property acquired Prior to June 17, 1987

The definition of "qualified property" originally was real property that is farm land and buildings

used by the farmer, spouse, or child, or a family farm partnership or corporation in the course of carrying on a farm business. For this definition, if property is used by the appropriate person in the year of sale or for any five year period prior to the year of sale, in the business of farming, then the property will be qualified farm property.

Under these rules, it is apparent that a surviving spouse, whose deceased husband has farmed the land in the previous five years while he was living, would qualify under this definition of qualified farm property.

This provision whereby farmland can qualify for the exemption as long as it **has been farmed for at least five years prior to the year of disposition is a very important regulation**. Under these rules a farmer could have rented his land for the last ten years and will qualify for the capital gains exemption as long as he meets the five year test. This is entirely different to the **rollover provision** which was discussed earlier, **whereby a farmer must be actively engaged in the business of farming in the year of disposition.** In essence, this will allow a retired farmer now renting land to a non-family member to qualify for the full exemption.

The definition of "qualified property" has been expanded to include property that is **owned** by a family farm partnership, of an individual or spouse of the individual and **owned** by certain trusts. Furthermore property that was **used by a parent** of the individual will also qualify. These two technical points are of importance as a partnership can now sell property and have the capital gains exemption apply to the partners.

Having parents qualifying as eligible users allows a child to rent land back to a parent who is presently engaged in the business of farming with the child qualifying for the exemption as long as the parent farms the land for at least one year before a sale is negotiated. Alternatively, if a child has owned land for a number of years and his parents have used that land in the business of farming for at least five years, then the child would also qualify for the $500,000 capital gains exemption even though the land is now rented to a non-family member.

Farm Property acquired After June 17, 1987

Ownership Rules. In order to qualify for the exemption for property acquired after June 17, 1987, the rules relating to the **ownership** of the property are the same except that an **individual's parents** are included in the category of eligible owners during the time period requirement to meet the use test. The additional time requirement is that property acquired after June 17, 1987 be held for at least 24 months immediately before disposition to be eligible for the exemption.

Business Use Rules. Not only must the property be owned for at least 24 months, but while so owned, in at least two calendar years, the farming gross revenue of the individual, spouse, child, trust or parent of the individual by whom the property was used, must exceed the net income from all other sources in the year for that person. Furthermore that person or trust must be actively engaged on a regular and continuous basis in the business of farming.

Alternatively, the property could be used by a family farm corporation or partnership of the individual, or the spouse, child, or parent of the individual in carrying on the business of farming, where such a person was actively engaged on a regular and continuous basis. In this situation there is no requirement of gross revenue exceeding net income from other sources, but only the property be used for at least 24 months.

(As a result of these changes, the government is taking steps to eliminate the use of the $500,000 capital gains exemption as a quick flip tax shelter for real estate investment.)

If an individual acquires farm land after June 17th, 1987 and wishes to sell the land and qualify for the exemption, he, his spouse, or his parents must have owned the property for at least two years and meet the gross revenue test. The new rules therefore, provide for an expanded use of the exemption upon acquisition of land from parents or spouses.

For example, if a farmer dies and leaves his land to his spouse and assuming that a capital gain

will occur upon the sale by the widow, she will qualify for the capital gains exemption even though the property was acquired after June 17, 1987. In other words, the spouse **does not have to own the property for a further two year period and be actively engaged in the business.** Revenue Canada has stated that as long as the deceased spouse had owned the property for at least two years and met the gross revenue test that the spouse and/or child will qualify for the exemption.

All farmers who wish to dispose of their property should clarify whether or not they qualify for the $500,000 exemption. This exemption is very important to the farming community as many farmers have experienced a relatively large growth in their asset values. All farmers should acquaint themselves with the rules and regulations of this amendment and incorporate the exemption into their estate plan.

To summarize these rules, the table entitled "The $500,000 Exemption Reference Guide" is provided at the end of this chapter.

Planning with the $500,000 Capital Gains Exemption

If a property transfer is one of the objectives of the farm family, then serious consideration should be given to accelerating the transfer under the present tax system. The reason simply being the utilization of the $500,000 capital gains exemption. Remember, there is no guarantee that the exemption will become a permanent fixture in our tax system.

Spouse to Spouse Transfers

As discussed earlier, a transfer to a spouse is deemed to take place at the tax base value of the asset transferred. However, a spouse can elect for fair market value treatment to apply on sales to a spouse. A simple letter with your tax return will suffice. This results in a capital gain usually being triggered on the transfer with the transferor claiming part or all of his capital gains exemption. It is important to note that the attribution rules will still apply on this type of transfer as a gift has really taken place albeit at fair market value. In order for the attribution rules not to apply, the recipient spouse must actually pay for the property at fair market value with the transferor spouse receiving the proceeds. If the transferor spouse is going to carry a loan on that sale, the attribution rules do not apply if the loan has:

- interest charged on the loan at a reasonable rate or at the rate prescribed for income tax purposes (if lower). (The prescribed rate for the 3rd quarter of 1988 is 9%.);
- the interest payable for each year is paid within 30 days at the end of that year.

If the recipient spouse has not paid F.M.V. and sells the property in the future and the property has increased in value, the attribution rules will apply resulting in the capital gain accruing back to the original owner of the property. If, however, the transfer took place at fair market value with proceeds actually received or a loan carried by the spouse pursuant to the above rules, then the capital gain will accrue to the recipient spouse. The recipient spouse will then, depending on eligibility, be able to claim his own capital gains exemption.

The following illustration will help explain this rule:

- In the example, Mr. X. is transferring to Mrs. X a quarter section with an A.C.B. of $16,000 and F.M.V. of $76,000 in 1988.
- Mr. X has decided to simply transfer the land to Mrs. X for no actual cash consideration and has elected to have the fair market value treatment apply to the transfer.
- Mr. and Mrs. X have decided 3 years later to sell this quarter for $106,000 to Mr. Y.

FACTS:

Mr. X to Mrs. X	1988
Proceeds of disposition	$76,000
A.C.B. Value	16,000
Capital Gain	60,000
Taxable Cap. Gain	$40,000
Apply Cap. Gains exemptions	($40,000)
Taxable Income	Nil

FACTS:

Mrs. X to Mr. Y	1991
Proceeds of disposition	$106,000
A.C.B. Value	76,000
Capital Gain	40,000
Taxable Cap. Gain	30,000
Apply Cap. Gains exemptions	NOT AVAILABLE
Taxable Income	$30,000 Attributed back to Mr. X

If Mr. X has not used up his $500,000 capital gains exemption, the $30,000 attributed back to him from his wife's subsequent sale of the quarter to Mr. Y can be offset. If Mrs. X had actually paid cash for the property, then Mrs. X would have been entitled to her own personal $500,000 capital gains exemption with no attribution of the taxable gain to Mr. X.

Parent To Child

Similar to the transfer discussed above, a farmer could consider charging fair market value to a child for property rather than a rollover value. This will achieve a tax cost (ACB) bump in the value of the transferred property and utilize part or all of the $500,000 capital gains exemption. **It is necessary however in inter-generational transfers that actual cash consideration be exchanged in order to achieve the desired strategy of increasing the tax cost base.** Unless actual cash consideration is received, the transfer price will be deemed to be the tax cost under the rollover provision.

In order to explain one strategy for transferring of property to a child using the $500,000 exemption the following example is provided.

Assume:

Land F.M.V.	$ 90,000
A.C.B.	16,000
Terms of Sale (over 15 years @ 0% equals $6,000 per annual payment)	90,000
Income to Taxpayer	
Capital Gain	$ 74,000
Taxable Gain @ 2/3	49,333
Apply Exemption	($49,333)
Taxable Income for Regular Tax	$ 0
Minimum Taxable @ 1/3	$ 24,667
Apply Exemption	(40,000)
Taxable income for minimum tax	$ 0

RESULTS:

PARENTS

1. The $6,000 annual payment will be received tax free due to the $500,000 capital gains exemption being partially used in the year of sale.
2. The child owes the parents $90,000 on the property, thus if subsequently sold by the child, the parents will receive the outstanding principal balance on the loan.
3. With the parents either retaining title under an Agreement for Sale or a mortgage, the child cannot quickly pledge the land as security for additional borrowings as a large debt is still owed to the parents. The child will have to make several yearly payments before any equity exists in the land except through increases in general land values.

CHILD

The child cannot deduct any of the $6,000 annual payment as there is not an interest component. The tax base (ACB) for the child however, is now at F.M.V. Although F.M.V. is charged with little or no interest, repayment ability usually exists. Payments @ 0% approximate only 1/2 the actual payment required @ 9% financing.

Although a large debt is attached to the land at least the ownership issue is settled and security for both parties has been established.

Other Considerations. If the parents wish, an interest rate can be charged on arrears, or a general increase can be established over a certain term of years.

For example, the interest rate could increase every third year resulting in a form of indexed income pension for the parents. By analyzing the amortization tables a smooth increase in the annual payment required can be obtained. A child under this arrangement will get some tax relief as the interest will be deductible.

It is important to note that zero interest appears to be allowed by Revenue Canada as long as the selling price negotiated for the property does not exceed the actual fair market value. In other words, Revenue Canada will not allow a taxpayer to increase the sale price of the

property in order to receive additional funds that would normally represent an interest rate charge.

The mortgage or agreement for sale retained by the parent can be left to a spouse or to a non-farming child upon the taxpayer's death and the recipient may continue to receive the funds tax free under the agreement. This is a very important estate planning mechanism whereby the farming child can receive the property while the parents are still alive and yet the non-farming children can continue to receive the payments upon the parents' death. A non-farming child receiving $5,000 of non-taxable income is equivalent to that child having to seek employment, paying approximately $9,000 in order to net the same after-tax funds. On the other hand, the parents may decide to forgive all or part of the outstanding debt upon their death. Due to a recent change in the Income Tax Act there is no adverse tax consequence on testamentary forgiveness of debts.

Corporate Transfers

In order to utilize the $500,000 exemption, some taxpayers are analyzing the benefits offered, by transferring their property to corporations and partnerships. This option is becoming popular where a sale to a third party is not being contemplated.

Historically, property was transferred to a corporation or partnership on a tax deferred rollover without an immediate tax liability. In the case of land, this value would be the adjusted cost base. The difference in value between this number and the fair market value of the asset was reflected in the value of corporate shares or partnership interest owned by the taxpayer personally. With the introduction of the $500,000 capital gains exemption, however, an individual should look at not a "rollover" of property to a corporation or partnership, but rather a sale at F.M.V. of property to his new business entity. The result could be, in the event of land, a capital gain. Assuming the exemption is available to the individual then such a sale may not result in any tax liability being triggered.

The following example will help illustrate this concept.

- Mr. X has decided to sell a 1/2 section to his newly formed corporation and will receive a demand note in exchange for the land. The demand loan stipulates that 25 equal annual instalments of principal with 5 per cent interest are required.
- The selling price is $160,000 with an adjusted cost base of $40,000

SALE FACTS

	1988
Proceeds of disposition	$160,000
Adjusted cost base	40,000
Capital Gain	120,000
Taxable Capital Gain	80,000
Apply maximum exemption available	80,000
Net taxable capital gain in year of sale	NIL
Net taxable capital gain in remaining sale term	NIL
Interest income in year of sale	8,000
Taxable income in year of sale	8,000

In the above example, Mr. X. will receive in the first year $6,400 of the principal repayment from his corporation and $8,000 in interest. The principal portion will, because of the exemption, result in no personal income tax, however, the interest portion of the payment will be a deduction to the corporation and income to Mr. X. Since the entire capital gain is being reported in the year of sale, subsequent repayment of principal will result in no taxable income to Mr. X.

The corporation will now own the land with a debt held by Mr. X for the $160,000 value. This debt should be registered as a mortgage or caveat in order to protect this debt, even if the corporation is owned by Mr. X. The following are some points that should be considered before the strategy is contemplated.

- A capital gains reserve is not available when property is transferred by an individual to a corporation controlled by the individual. This restriction means a transfer of land triggering more than $120,000 of capital gains in 1988

and 1989 or $160,000 of capital gains in 1990 and subsequent years, may trigger the Alternative Minimum Tax. Without the capital gains reserve, a sale triggering capital gains in excess of the above maximums cannot be spread over a number of years and accordingly the $40,000 basic exemption for A.M.T. may be exceeded.

- If the land is ever subsequently sold by the corporation, a capital gain will occur if that value exceeds $160,000. Remember, a corporation does not qualify for the $500,000 exemption and thus any gain on the land transferred will become taxable at the corporate rate.
- If the land is ever subsequently re-acquired by Mr. X, the corporation will be deemed to receive fair market value consideration for the disposition and be faced with tax on any potential capital gain. If the debt or any portion of the debt is still owing to Mr. X, then this debt can be extinguished upon acquisition of the property. If however, the fair market value of the property exceeds the debt, then additional funds will have to be paid to the corporation to be able to "purchase" the property from the corporation. These funds can then only be withdrawn from the corporation in the form of salary or dividend which may be subject to personal tax.

If no payment is made to the corporation for this difference in value between the fair market value and the debt outstanding, Mr. X. is deemed to have received a taxable benefit equal to this difference. If the difference is paid by an assumption of debt, the debt must be paid within one year otherwise the amount will be included in income as a taxable benefit.

For example, if the land transferred increases in value to $180,000 and the outstanding principal balance owing is $120,000 then the $60,000 difference in value must be actually paid to the corporation, or Mr. X. will be taxable on a $60,000 deemed benefit. The $60,000 benefit will not be added to Mr. X's adjusted cost base of the land which will remain at $120,000.

Partnership Transfers

The same format as described in the above example for utilizing the $500,000 exemption through a corporation can be accomplished by using a family farm partnership. The major difference between the two business arrangements is that a family farm partnership will continue to be eligible for the $500,000 exemption if the property increases in value. Note, however, that only $500,000 of capital gains exemption can be claimed by the individual which includes any share of capital gain incurred in his partnership.

The following points should be considered before assets are transferred into a partnership.

- A capital gains reserve is available when transferring property to a partnership. This rule will allow a sale of land to occur triggering a $500,000 capital gain with the reserve being claimed for the outstanding debt in order to avoid the application of minimum tax. The maximum reserve available on this type of transaction is five years.
- If the land is ever subsequently re-acquired by Mr. X, the partnership will be deemed to have received fair market value consideration upon the disposition. Any resulting capital gain that will arise from the transaction will be allocated to the partners according to their partnership agreement. If the debt or any portion of the debt is still owing to Mr. X, this debt can be extinguished upon acquisition of the property. If however, the fair market value exceeds the debt, "additional funds" will be needed by Mr. X to re-acquire the property. These funds will then be divided according to the partnership agreement resulting in Mr. X personally being responsible for the net difference between the funds needed to re-acquire the land and his share of these same funds received.

Assuming a 50/50 partnership between Mr. and Mrs. X, and the same land values and debts, Mr. X will require $30,000 of additional funds to re-acquire his property. However, repayment of these funds from Mr. X to his partnership does not fall into the same treatment as for a

corporation. That is, a deemed taxable benefit will not result if the loan is not repaid within one year. Mr. X could therefore owe the partnership these funds payable over a number of years without any adverse tax consequences.

Conclusion

As can be seen, the utilization of the $500,000 capital gains exemption through the use of personal partnerships or corporations is indeed very complex. Once created, corporations and partnerships have very strict tax rules that must be complied with. In addition, if the sole purpose of a corporation or partnership is to simply utilize the $500,000 exemption, then the possibility of the general anti-avoidance rules (GAAR) may come into play. It is therefore very important that a thorough discussion of the ramifications of creating partnerships or corporations be initiated with your advisor specializing in income tax.

THE $500,000 EXEMPTION REFERENCE GUIDE
For Disposition in 1988 and Subsequent Taxation Years

Acquired Prior to June 18, 1987

PROPERTY

- Real property (land and buildings).
- Partnership interest or corporate shares of a family farm partnership or corporation.
- Eligible capital property (quotas).
- Machinery and all other capital property limited to $100,000 and not included in these rules.

PROPERTY OWNERSHIP

- Owned by a taxpayer, spouse or family farm partnership of the taxpayer or spouse.
- Owned by a trust where the beneficiary is related to the owners of the property from whom the trust acquired the property.

PROPERTY USE (not applicable to partnership interest or corporate shares)

- Must be used in the year of disposition or have been used in the business of farming for at least 5 years by either the taxpayer, spouse, trust, child or parent of the taxpayer, including a corporation or partnership of any of these individuals.

Acquired after June 17, 1987

PROPERTY

- Real property (land and buildings).
- Partnership interest or corporate shares of a family farm partnership or corporation.
- Eligible capital property (quotas).
- Machinery and all other capital property limited to $100,000 and not included in these rules.

PROPERTY OWNERSHIP

- Same as for property acquired prior to June 18, 1987 plus:
- Property must be owned for at least 24 months immediately prior to disposition by the owners described under ownership.

However, during this 24 month ownership period a parent or child could have owned the property and their ownership time will be added to that of the present owner of the property.

PROPERTY USE (not applicable to partnership interests or corporate shares)

- Used in the business of farming for at least 24 months by either the taxpayer, spouse, trust, child or a parent of the taxpayer and that person who used the property was actively engaged on a regular and continuous basis and the gross revenue from farming exceeded all other sources of net income for that person.
- Or, if the property is used by a family farm partnership or corporation, the property must be used for at least 24 months, during which time the owner of the partnership interest or corporate shares must be engaged in farming on a regular and continuous basis. The gross revenue requirement does not apply to property used by a corporation or partnership.

Farm Losses

Although the terms hobby farmer and gentleman farmer are often used in referring to individuals who keep a few animals or grow a few acres of crops or vegetables, the Income Tax Act does not make use of these terms. The major problems with hobby farmers are: 1) whether their operation constitutes a farming business for income tax purposes, and 2) the amount of loss, if any, which can be deducted from other income. To understand how the income tax laws work with regard to farm income and losses, it is necessary to distinguish three types of farmers.

Classification of Farmers For Tax Purposes

First of all there is the person who carries on a farming operation but has **no real expectation of ever making it a profitable venture.** In such cases, **none** of the expenses incurred in the farm operation would be deductible for income tax purposes as they would not have been incurred for the purpose of earning income from a business. They would be considered to be personal or living expenses of the individual to the extent these expenses exceed any related income. Such a person would normally depend on a source of income other than farming to provide for his needs.

Next, there are the persons who can truly be said to be in the business of farming because their farming operations do hold a reasonable expectation of profit. However, farming is not their **chief source** of income. Nor can it be said that farming and some other source (such as employment) constitute their chief source of income. Nevertheless they are engaged in the business of farming with the intention of making a profit and must report the revenue and may deduct the expenses incurred to earn it. These persons are often called hobby farmers or gentleman farmers. They are treated essentially the same as a **bona fide** (full-time farmers) farmers except that they may be restricted in the amount of farm losses that can be claimed against other income, and are not entitled to use the five-year block averaging provision. Whether or not farming constitutes their chief source of income is the basic test in all cases. For simplicity, we will refer to all persons in this category as hobby farmers.

The last category of course, is the full-time farmer whose operations are unquestionably the chief source of income. All of the special provisions which exist for farmers under our tax laws are available to this individual.

The facts in each case will always determine which of the three categories is appropriate. Many taxpayers have gone to court in an attempt to establish that they were hobby farmers or full-time farmers when the tax department did not agree and either denied or restricted the losses which they attempted to claim.

There are a great many court cases on this subject, each with their own peculiarities and each one decided on its own particular facts.

Court cases have given a clearer indication of the criteria used to distinguish hobby farmers from bona fide farmers. The primary case in this respect is the Supreme Court of Canada decision of Moldowan v. The Queen (1977). The prime distinguishing factors were taken to be:

- the time spent in the farming operation;
- the capital committed to the operation;
- the profitability of the operation, both actual and potential;
- a clearly demonstrated intention to make farming a chief source of income.

Recent cases have used these criteria in deciding whether a farming operation belongs in the hobby farm category or the full-time category. Cases to note would be Graham v. The Queen (1985), Kasper v. The Queen (1983) or Bio-Test Labs v. MNR (1982).

Interpretation Bulletin IT-322R on this subject would be of interest to people who operate farming businesses in addition to having other income-earning activities. You should also

consult your tax advisor for current trends if you are in this position.

The tax regulations affecting the hobby farmer can be summarized by answering the following questions:

How Are Farm Losses Determined?

For taxation years that commence prior to 1989, farmers will calculate losses on a cash basis as discussed on page 6 to 8 of this booklet. The restrictions on deducting losses, as discussed in the next section, are calculated on this relatively simple cash basis.

Tax Reform

*For taxation years commencing after 1988, however, the rules for determining cash losses are considerably more complex. These new rules will continue to permit farmers to report income on a **cash** basis.*

*However, in the year that a cash **loss** is incurred, the farmer will be required to decrease the loss to the extent that he has **purchased** inventory on hand at year end.*

In the year that a farmer incurs a cash loss he will be required to add a mandatory inventory adjustment (M.I.A.) to his income. This adjustment differs from the flexible livestock inventory election in that:

1) *it will be mandatory;*
2) *it will apply only to **purchased** inventory; and*
3) *it will apply only in loss years.*

The amount of the M.I.A. will be the lesser of:

1) *the net farm loss calculated on a cash-basis (including recaptured depreciation and net of capital cost allowance); and*
2) *the value of purchased inventory on hand at year-end.*

Understandably, any M.I.A. amount included in income in a year must be deducted in the following year.

Example

Year 1

Farmer A has a cash-basis net farm loss of $30,000. He also has $50,000 worth of inventory on hand at year end, $21,000 of which was purchased in year 1 and prior years.

Cash-Basis Loss	*$(30,000)*
Add M.I.A.:	
Lesser of	
1) Loss $30,000	
2) Purchased inventory $21,000	*21,000*
Deductible farm loss	*$ (9,000)*

(In addition to the M.I.A., Farmer A may add to his income, a flexible inventory amount of up to $29,000 ($50,000 - $21,000).

Year 2

Farmer A has a $2,000 cash-basis farm income and $60,000 of inventory on hand at year end; $14,000 of which was purchased in year 2 and prior years. No flexible inventory adjustment was reported in Year 1.

Cash-Basis Income	*$ 2,000*
Deduct Prior year M.I.A.	*(21,000)*
	(19,000)
Add current year M.I.A.:	
Lesser of	
1) Loss $19,000	
2) Purchased inventory $14,000	*14,000*
Deductible farm loss	*$ (5,000)*

As is evident from these examples, the M.I.A. will have a significant impact on the deductibility of farm losses by farmers with large purchased inventories. Accordingly, the government has developed transitional rules which will effectively phase in the 1989 opening value of purchased inventory over 6 years.

Phase-in Period for Mandatory Inventory Adjustment (1989-1994)

The transitional rules apply to fiscal periods commencing after 1988. By 1995 the rules will be fully phased in such that the M.I.A. rules as explained above will be in effect. Under the transitional rules taxpayers have a choice between the fixed dollar and elective methods of calculating the inventory adjustment. Again both

methods only apply if farm cash losses have been reported.

***Fixed-Dollar Method**. The fixed-dollar method will apply in any transition year unless you elect otherwise. This method allows you to **reduce** your M.I.A. from what it would otherwise be by a fixed dollar amount each year. The fixed dollar amount is $15,000 in the first taxation year commencing after 1988, $12,500 in the second, and $10,000, $7,500, $5,000 and $2,500 in the third to sixth years respectively.*

***Elective Method**. You may choose to use the elective method if it provides a more favourable result than the fixed-dollar method. Using the elective method the M.I.A. amount will include only a portion of the purchased inventory on hand at the end of the transition year and the last taxation year commencing before 1989. That portion will be 1/7 in 1989, 2/7 in 1990, 3/7 in 1991 and so on, to 1994.*

Therefore the M.I.A. amount for 1989 under this method will be the lesser of:

1) *the loss; and*

2) *the aggregate of:*

- *1/7 of the value of inventory that was purchased before 1989 and is on hand at the end of the 1989 taxation year; and*
- *the value of all other purchased inventory on hand at the end of the 1989 taxation year.*

Example - Comparison of Fixed-Dollar and Elective Methods

1989-Farmer A incurred a cash-basis farm loss of $30,000. He has $50,000 worth of inventory on hand at year end, $21,000 of which was purchased prior to 1989. He made no purchases in 1989.

(a) Fixed-Dollar Method			
Cash-basis loss			$(30,000)
Add M.I.A.:			
Lesser of:			
(1) the loss	$30,000		
(2) purchased inventory	21,000	$21,000	
Less transitional relief		(15,000)	6,000
Deductible farm loss			$(24,000)
(b) Elective Method			
Cash-basis loss $(30,000)			
Add M.I.A.:			
Lesser of:			
(1) the loss		$ 30,000	
(2) the aggregate of:			
a. pre-1989 purchased inventory x 1/7 ($21,000 x 1/7)		3,000	
b. post 1989 purchased inventory			
	0 =	3,000	3,000
Deductible farm loss			$(27,000)

If Farmer A has sufficient off-farm income to utilize the $27,000 loss and to make use of any other deductions and tax credit available to him, he should use the elective method. If on the other hand Farmer A cannot make use of the $27,000 loss in 1989 he may want to choose the fixed-dollar method in 1989 because it would provide him with a larger deduction in 1990. In other words, if Farmer A uses the fixed dollar method in 1989 he will deduct $6,000 in 1990. If

he uses the elective method in 1989, his 1990 deduction will only be $3,000.

1990

Assume Farmer A used the fixed-dollar method in 1989. He earned $2,000 of cash-basis farm income in 1990 and has $60,000 worth of inventory at year end consisting of the following:

$ 7,000	*purchased before 1989*
7,000	*purchased in 1990*
46,000	*non purchased*
$60,000	

Example - Comparison of Fixed-Dollar and Elective Methods

(a) ***Fixed-Dollar Method***

Cash-basis income			*$ 2,000*
Less 1989 M.I.A.			*(6,000)*
			(4,000)
Plus 1990 M.I.A.			
Lesser of:			
1) the loss	*$ 4,000*		
2) purchased inventory	*14,000*	*4,000*	
Less transitional relief		*12,500*	** 0*
Deductible farm loss			*$ 4,000*

** (The M.I.A. cannot be negative)*

(b) ***Elective Method***

Cash-basis income			*$ 2,000*
Less 1989 M.I.A.			*(6,000)*
			(4,000)
Plus 1990 M.I.A.			
Lesser of:			
(1) the loss		*$4,000*	*4,000*
(2) the aggregate of:			
a. pre-1989 purchased inventory x 2/7			
($7,000 x 2/7)	*$2,000*		
b. post -1989 purchased inventory			
	7,000	= *9,000*	
Deductible Farm loss			*$ 0*

In this example the fixed-dollar method provides Farmer A with a larger shelter for off-farm income in 1990 than does the elective method. The elective method provides a larger shelter in 1989.

The optimum method will vary, depending on each farmer's circumstances. It appears that the farmer will have to calculate his results for his situation in each taxation year.

What is Inventory

The flexible inventory election and the M.I.A. rules apply to inventory owned in connection with a farming business. Generally this includes items of a saleable nature such as grain, livestock, straw, honey and other farm produce. Livestock that is subject to the special provisions for "basic herds" are excluded. Inventory also includes supplies used in the farm operation such as fuel, twine and other items that tend to be consumed within one year. The Department of Finance has advised that purchased inventory does ***not*** *include applied fertilizer and chemicals.*

Valuing Inventory

It is the ***fair market value*** *of inventory that may be added to a farmer's income under the flexible inventory election. For purposes of the M.I.A., purchased inventory is generally valued at the* ***lower of its original cost and its fair market value.*** *Special provisions were introduced in the June 13 legislation in respect of valuing certain animals, called "specified animals", for the M.I.A.*

Specified Animals

All horses are "specified animals". In addition, cattle registered under the Livestock Pedigree Act may, at the farmer's option, be classified as a specified animal. This election may be made on an animal by animal basis.

The specified animal rules are only for the purpose of valuing inventory for the M.I.A.

Therefore, in the case of these animals the new valuation rules replace the lower of cost and market rule. A specified animal will be valued at its original cost less 30% per year on a diminishing balance basis, unless the taxpayer chooses to value the animal at a greater amount (not to exceed its original cost). Transitional measures have been introduced to phase in the specified animal rules as well. For specified animals purchased in taxation years:

- *commencing in 1988 or later, the value for tax purposes will be 100% of original purchase price,*
- *commencing 1986 or 1987, the value for tax purposes will be 50% of original purchase price,*
- *commencing in years 1985 or earlier, the value for tax purposes will be 25% of original purchase price.*

For the purpose of these transitional rules, a specified animal purchased from a non-arm's length vendor is deemed to have been purchased when the vendor originally acquired the animal.

Example

At December 31, 1989 Farmer A owns 2 race horses, one of which he bought in 1987 for $40,000. He acquired the other in 1989 for $60,000. His cash-basis farm loss in 1989 is $70,000. Farmer A decides to use the fixed-dollar method.

Cash-basis loss				*$(70,000)*
Add M.I.A.:				
Lesser of:				
1) the loss		*$70,000*		
2) purchased inventory				
1987 horse:				
50% x $40,000 x 70%	*$14,000*			
1989 horse:				
100% x $60,000 x 70%	*42,000*	*56,000*	*56,000*	
Less transitional relief			*(15,000)*	*41,000*
Deductible farm loss				*$(29,000)*

Conclusion

The June 13, 1988 amendments will make life very difficult for those farmers incurring a cash basis loss in the year 1989 to 1994, because of the transition rules. If these farmers have an inventory of horses or registered cattle the specified animal rules seem arbitrary. Consequently, it is not possible to formulate effective rules of thumb to deal with the calculations.

The other issue of controversy is the recordkeeping required necessary to comply with the new rules. At the time of printing, Revenue Canada had no forms available nor any practical procedures for farmers to "track" their inventory purchases and sales. This administrative requirement could prove to be very difficult depending on the size and complexity of your farm business.

What are the Loss Restrictions for Hobby Farmers?

The Income Tax Act states that where a taxpayer's chief source of income for a taxation year is neither farming nor a combination of farming and some other source of income, a loss sustained from the business of farming is only allowed to reduce income of that year from all other sources to the extent of the lesser of:

a) the farming loss for the year, or

b) $2,500 plus the lesser of,

   i) one half of the amount by which the farming loss for the year exceeds $2,500 or

   ii) $2,500

In other words, a hobby farmer is limited to an overall farming loss deduction against other income of $5,000. The farming loss for the year would have to be at least $7,500 in order to deduct the maximum amount. Consider the following example:

In 1986 a hobby farmer incurred a farming loss of $4,500. In 1987, further losses of $5,000 were incurred. In 1988 a farming income of $1,000 was earned.

Under the restricted loss provision, the loss deduction is calculated as follows:

1986: $4,500 Farming Loss
Maximum deduction =

$$\$2,500 + \frac{(\$4,500 - 2,500)}{2}$$

$$= \$2,500 + 1,000$$
$$= \$3,500$$

The unused portion ($4,500 - 3,500 = $1,000) is the "restricted farm loss".

1987: $5,000 Farming Loss
Maximum deduction =

$$\$2,500 + \frac{(\$5,000 - 2,500)}{2}$$

$$= \$2,500 + \$1,250$$
$$= \$3,750$$

The unused portion ($5,000 – $3,750 = $1,250) is the "restricted farm loss".

Total restricted farm loss is $2,250 ($1,000 + $1,250).

For the 1986 and 1987 taxation years, the hobby farmer has been allowed to deduct $3,500 and $3,750 in losses from other income for each year. However, restricted farm losses arose in each of these years. These losses may be carried back three years or forward ten years from the year in which they are incurred. The restricted farm losses, however, may **only** be applied against **farming income**.

In 1988, the hobby farmer earned a farm income of $1,000. The restricted farm loss would be applied against this income:

Farm Income	$1,000
Less:	
Loss Carryover	$1,000
Net Farm Income	$ 0

In this example, the earliest restricted farm loss is used first (1986) and a balance of $1,250 in restricted farm losses remains to be carried forward and applied against future farming income.

***Tax Reform**. For taxation years commencing after 1988, the loss restriction will be increased*

to $2,500 plus one-half of the next $12,500 for a maximum of $8,750.

Can Hobby Farmers Use the Cash Method of Reporting Their Income?

Yes. As discussed earlier, the cash method can be used to report farm income by all persons who are in the business of farming. If a current loss exceeds the amount which would currently be deductible, a hobby farmer who raises livestock can bring in part or all of the value of the livestock inventory and reduce the amount of the loss. This rule gives hobby farmers who have livestock inventories considerable flexibility in the amount of income or loss which they may wish to report. It is another good reason for a person in the farming business to use the cash method of reporting income.

Can a Hobby Farmer Use All the Income Averaging Methods Which are Available to a Fulltime Farmer?

No. A hobby farmer cannot use the five-year block-averaging method because only individuals whose chief source of income is from farming can use that method. However, all the other types of averaging which were discussed earlier are available to hobby farmers.

Can Hobby Farmers Use the Special $1,000 Per Year Exemption for Gains on a Principal Residence Situated on the Farm?

Yes. A hobby farmer can use this special rule in the same manner as a full time farmer as long as the property is a principal residence which is situated on land used in a farming business that was carried on by the farmer. As outlined earlier, when the property is disposed of, there are two ways in which a farmer can calculate the amount of capital gain which will be exempt from tax under the principal residence rules. The principal residence portion can be severed from the rest of the farm to determine the exempt capital gain, or a special exemption can be taken of $1,000 plus $1,000 for each year the farmer lived in the home since December 31, 1971.

Is the Investment Tax Credit Available for Depreciable Assets Acquired for Use by a Hobby Farmer?

Yes. Provided all tests for the investment tax credits are met, there is no reason why it cannot be claimed by a hobby farmer.

Are the Farm Rollovers Available to Hobby Farmers?

This is not an easy question to answer since so much will depend on the facts in each situation. All the requirements which have to be met to qualify for any of the farm rollovers were discussed earlier. Generally speaking, the rollovers under the Income Tax Act will apply to the hobby farmer just as they do to a full-time farmer.

Are Corporations or Partnerships Subject to the Restricted Farm Loss Provision?

Yes. If neither farming nor a combination of farming and some other source of income can be said to be the chief source of income of the corporation or the partnership members, the loss restrictions will apply. The fact that the taxpayer is a corporation or that the farming is carried on by a partnership (which must calculate its income as if it were a separate taxpayer) does not make any difference in the hobby farm rules.

If a Hobby Farm is Sold, What Happens to the Unused Restricted Farm Losses?

Property taxes and interest on borrowed funds to acquire property that are included in the restricted farm loss may be added to the cost base of the land for purposes of determining capital gains. The remaining restricted farm loss would be foregone.

Organization of the Family Farm

Of the tax planning strategies available to farmers, perhaps the most important is that of selecting the form of organization under which the business will be operated. The type of business organization which is used affects the taxation of the business, and in the longer run, has implications for estate planning.

This section looks at the types of business organization which are seen in farming, and discusses some of their advantages and disadvantages.

There are many tax and legal implications to any agreement. Since individual farm situations vary considerably, it is important that all factors be taken into consideration in deciding which form of business organization best suits the specific situation.

Sole Proprietorship

Sole proprietorship is the most common type of business arrangement in the farming community. The farm assets are owned by the farmer as an individual (or perhaps jointly with a spouse) and all the income produced by the business is reported by the farmer on the personal income tax return for the year. The farmer is in the same position under the law as any other individual who carries on a business.

Advantages of a Sole Proprietorship

- **Simplicity** – The sole proprietorship is popular because of its simplicity. The cost of starting up is lower, and it is cheaper to operate since accounting and legal advice are not as complex as with other types of business organizations.
- **Flexibility** – In a sole proprietorship, farmers can take action without having to consult anyone else because, generally, they must accept the consequences of their decisions. With this flexibility of operation, the sole proprietor can more easily adjust to changing conditions.
- **Income splitting** – Since 1980 a sole proprietor has been able to pay a salary to a spouse. This salary or wage must be reasonable for the type and amount of work being done by the spouse.
- **Income averaging methods can be utilized** – As discussed earlier, an individual farmer has two types of income averaging methods available to reduce the income tax burden: the five-year block-averaging, and the livestock inventory provision. However, it should be mentioned that corporations are subject to a flat tax rate and accordingly do not need to average income.
- **Offset losses against other income** – Any farm losses which are incurred are deductible from other income which the farmer may have. Such losses which are not claimed in the year incurred can be carried back three years or forward ten years.
- **Income tax instalments** – Unincorporated farmers only have to pay taxes twice a year, December 31st and April 30th of the following year.
- **Flexibility of fiscal year-end** – the proprietorship may select a fiscal year-end for its business and report income in the tax year in which the fiscal period ended. This could have some tax and business advantages.

Disadvantages of a Sole Proprietorship

- **Progressive tax rates** – All the income earned from the sole proprietorship is reported on the farmer's personal tax return. The income will be subject to tax at marginal rates, which range as high as 50% in some provinces. (45% in Alberta for 1988). As mentioned above, the income averaging methods available can be used to help spread out the tax burden, nevertheless, for farmers in high income brackets the tax can be excessive compared to other business arrangements.

- **No limitation of legal liability** – The sole proprietorship carries with it personal liability for the owner. In effect, whatever assets are owned, whether personal or business, are often committed to underwrite any financial obligations. The limited liability which a corporation provides (to a degree) may not make a great deal of difference in a practical, day-to-day sense, but such liability becomes important if the business is sued.

  Liability insurance may be an alternative to consider. However, if a farm encounters financial difficulties, any assets held outside a farm corporation could be protected from the claims of creditors. Where the farm is unincorporated, no such protection would be available.

- **Lack of employee benefits** – A sole proprietor is a self-employed person, so a number of the benefit plans which would be available to an employee do not apply. For example, such things as group insurance, deferred profit sharing plans and registered pension plans, could not be used.

- **Transferring ownership is more difficult** – In a sole proprietorship, ownership of the assets (such as real property, vehicles, equipment, etc.) is recorded in the farmer's name. Transferring the ownership of such a business is more cumbersome than when all business assets are owned by a limited company. In a sole proprietorship, each asset must be transferred separately. To transfer assets of a company, a shareholder need only transfer the ownership of the shares of the company.

- **Continuity of business not assured** – With only one person involved in a sole proprietorship, a lack of continuity can be brought about by an untimely death. As well, it is often difficult to make arrangements for a successor in this type of organization.

Partnerships

Prior to tax reform in 1972 partnerships were not recognized as separate entities for income tax purposes. The income earned by each partner of the business was taxable in the hands of the partner who had earned it, in a similar manner to the income from a sole proprietorship. Under the current tax laws, income for tax purposes is calculated primarily at the **partnership** level. As well, there is also a need to maintain a record of each partner's equity interest in each of the partnership's assets for tax purposes. The rules regarding partnerships have created a certain level of complexity in the tax laws.

The federal Income Tax Act does not define specifically what a partnership is. In Interpretation Bulletin IT-90, Revenue Canada states:

"Generally speaking, a partnership is the relation that subsists between persons carrying on business in common with a view to profit. (However), co-ownership of one or more properties not associated with a business, (which under common law might be a joint tenancy or a tenancy in common), does not of itself create a partnership, and this is so regardless of an arrangement to share profits and losses. For guidance on whether a particular arrangement at a particular time constitutes a partnership, reference should be made to the relevant provincial law on the subject and such law will be viewed as persuasive by the Department of National Revenue".

It is very important to determine whether or not a particular arrangement between two or more people will be a partnership for tax purposes. As indicated in the above statement, the co-ownership of property will not in itself indicate that a partnership exists. However, if two persons own a farm jointly and actively operate it together, sharing the net income (or loss) produced by the farm, there is a strong presumption that they are in partnership. Alternatively, where a farmer owns a farm but lets another person operate it on a share cropping basis, there would not be a partnership. The income from such an arrangement would be considered property income, which is treated in a similar manner to rentals.

It is important to remember that it is the facts of each situation which will decide whether or not a

partnership exists before the income tax consequences of the arrangement can be determined. If a partnership is desired, a formal partnership agreement should be drafted and executed for greater certainty.

Advantages of a Partnership

- **Simple to set up** – Setting up a partnership is relatively simple. The costs are not high in comparison to the creation of a limited company.
- **Continuity in illness** – Two or more persons can participate in the business enabling the pooling of resources. This results in a continuity of the business operation should one partner become ill.
- **Flexibility of fiscal year end** – The partnership may select a fiscal year end for its business and each partner would then report income from the partnership in the tax year that the fiscal period ended. This could have some tax and business advantages.
- **Averaging provisions available** – Income from a farming partnership will retain its character as income from a farming business in the hands of each partner. As a result, the income averaging methods discussed previously for a proprietorship may be used.
- **Tax-deferred rollover of property to a Canadian partnership** – As discussed earlier, it is possible for persons entering into a partnership arrangement to contribute property to the business without incurring an immediate tax cost. Such a rollover allows any gain on the property to be deferred until the partnership disposes of the asset or the partner disposes of the partnership interest.
- **Tax-deferred rollover of an interest in a family farm partnership** – The rollover of an interest in a family farm partnership to a child is possible. Details on qualifications are discussed in the section on property transfers.
- **Splitting of income between husband and wife** – It is possible to have a partnership between husband and wife and save tax through splitting income. However, the tax authorities may attempt to disallow the partnership and tax the income in one spouses's hands. Where both spouses are actively engaged in the business, or one spouse is actively engaged in the business and the other spouse has invested his or her own property in the business, the operation may qualify as a legitimate partnership for tax purposes. A tax case in this area has made the creation of husband and wife partnerships more acceptable. In this case, Berg v. MNR (1982), the judge upheld the taxpayer's contention that there indeed existed a husband and wife partnership even though no written partnership agreement existed. They were able to demonstrate that the wife had made substantial contributions, in capital and labour, and that she was actively engaged and quite knowledgeable about the farming operation. The subject of husband-wife partnerships is controversial, so each situation should be considered carefully.

Disadvantages of a Partnership

- **Complex tax accounting** – There are greater accounting costs for a partnership. Depending on the size and complexity of the agreement, they can be fairly large. In addition to accounting for the partnership, the cost base of each partner's interest in the partnership must be established to determine if there are any capital gains to be realized on transfer of a partnership interest or on dissolution.
- **Difficult to deal with partnership assets** – Where assets are owned by a partnership, a partner cannot deal with these assets as if they were owned personally. They cannot be sold without consent of the other partners nor left to a child in a will.
- **Difficult to collapse** – The dissolution of a farming partnership may give rise to unintended tax consequences. As this is a very complex area, it is advisable that competent legal and tax advice be obtained **prior** to any dissolution of a partnership.

- **Progressive tax rates** – As discussed in the sole proprietorship, partners who are individuals will pay progressive rates of individual tax. It should be noted that a partnership could also be formed between corporations or individuals and corporations.
- **No limitation of legal liability** – A sole proprietor has limited protection from any legal action. Generally, members of a partnership are not only liable for their own actions but are also jointly liable for the actions of business partners arising from the operation of the partnership. Limited liability partners, however, would only risk the loss of their capital investment should a legal dispute arise. Therefore, choosing a business partner is not something to be taken lightly.
- **Capital cost allowance at partnership level** – For depreciable assets owned by the partnership, capital cost allowance is claimed by the partnership before income is allocated to the individual partners. This reduces the flexibility of varying the claim to suit each partner's specific requirements. As well, the livestock inventory provision for animals owned by the partnership must be used at the partnership level.
- **Method of reporting income** – In a partnership, all partners must agree to the method of reporting income, that is cash or accrual.

Joint Ventures

A Joint Venture is a formalized business arrangement and is **not** a business entity such as a partnership or corporation.

Perhaps the best definition of a joint venture is that found in the Canadian Institute of Chartered Accountants Handbook. It is defined as follows:

"A Joint Venture is an arrangement whereby two or more parties (the venturers) jointly control a specific business undertaking and contribute resources towards its accomplishment. The life of the joint venture is limited to that of the undertaking which may be of short or long term duration depending on the circumstances."

In other words, a joint venture is the bringing together of two or more sole proprietors in order to farm jointly for profit. There is no intention to form a legal partnership. Each individual retains ownership of his/her assets.

There are two reasons for establishing a joint venture. The first, and the most important is that in a joint venture **all** the assets are owned, solely or jointly, by the venturers. Upon termination of the joint venture, there are no adverse tax consequences as the joint venture itself does not **own** any assets. Secondly, if a farmer no longer desires or is unable to perform the labour activities on a farm, it is possible to maintain an active farming status with a joint venture. This is accomplished by providing management and capital in lieu of labour. Therefore, the farmer is still able to roll the farm tax free to a child.

In view of the income tax implications of being involved in a partnership and in view of the close similarity between a partnership and a joint venture, it is important to ensure that the participants do not inadvertently create a partnership relationship. It should be pointed out that Interpretation Bulletin No. IT-90 sets out certain general rules for determining whether or not a business relationship is that of a partnership or one which constitutes a joint venture.

In the farm community, this point of clarification is vital. Many parent/child arrangements are really a type of joint venture, however, the tax returns are incorrectly filed as a partnership. All "ownership costs" such as capital cost allowance, property taxes and interest on debt are claimed collectively on the returns and not individually. The question that arises from a tax point of view is whether or not a partnership has been created which owns the asset.

Corporations

The corporation is another form of business organization that the farm unit can use. The corporation (or company) is a separate legal "person" for income tax purposes.

Where a farmer decides to incorporate, by transferring assets into a corporation, the corporation is in the business of farming. Using the rollover discussed earlier, the farmer receives shares in the corporation and becomes a shareholder of the corporation.

The farmer may also be an employee of the farm corporation. A spouse and/or children may be shareholders or employees as well, depending on how the organization is set up and the purposes it is designed to achieve.

The corporation is different from the sole proprietor and partnership forms of business organization in that it does not pay income tax at progressive rates on its earnings. In 1988 the federal tax rate for small business corporations was approximately 12%. This rate applies to taxable income from $1 to $200,000 each year. The provinces levy taxes on small business corporations at rates varying from 3% to 10% (Alberta 5%) which form combined rates ranging from 15% to 22%. (Alberta 17%) If taxable income exceeds the $200,000 limit, the combined tax rate is approximately 44% on the amount in excess of this limit. The shareholders also pay tax on any dividends received from the corporation. The amount included in the shareholder's income is equal to 125% of the actual dividend received. However, there is also a dividend tax credit which the shareholder can claim. This dividend tax credit of 13 1/3% of the grossed up amount, effectively gives the shareholder a credit for the taxes paid by the corporation. The effect of the corporate income tax, and gross-up and dividend tax credit mechanism is that the same amount of tax will be paid whether income is earned by a corporation or by an individual. This concept is known as "integration". As can be seen from the following example (ignore surtaxes) the rate of 41% is approximately equal to the top personal rate of 42.5%.

Assume that the combined corporate tax rate on small business income is 25% and that the shareholder is in a 42.5% marginal tax bracket.

CORPORATION	
Income earned by corporation	$100.00
Income tax paid (17%)	17.00
Income available for distribution	$ 83.00
Dividend paid to shareholder	$ 83.00
SHARHOLDER	
Dividend received	$ 83.00
Gross-up (25%)	20.75
Taxable income	$103.75
Federal Income Tax (29%)	$ 30.08
Dividend tax credit (13 1/3%)	(13.82)
	16.26
Provincial tax liability (46.5%)	7.56
Total Tax	$ 23.82
Corporation - Income Tax	$ 17.00
Shareholder	24.00
	$ 41.00

It should be noted that, owing to the differing provincial tax rates, the actual results may differ but the mechanics will be the same. For example, in Alberta, where the provincial tax rates are lower, there would be a benefit to earning income through a corporation in that the total taxes paid will be lower than if the income was earned personally.

The other benefit from a tax point of view arises when the shareholders are able to leave income in a corporation. The first incidence of tax, which is at the corporate level, will be at a lower rate than personal rates on the same amount of income. The second level of taxation does not arise until funds are actually paid out to a sharholder as dividends. Accordingly, if the funds are left in a corporation, a larger amount of cash would be available for investment in the farming operation than if the same amount of income was earned by an individual. Generally the optimal position is found where an individual's employment income from the farm corporation is sufficient to raise the individual's marginal tax rate to the level of the corporate tax rate (17% for Alberta).

Generally speaking, as far as the day-to-day operation of the farm is concerned, not a great deal will appear to have changed. However,

there are some details which will change. For example, purchases and other expenditures will be made in the corporation's name, sales of farm products will also be made in this name, and a bank account will exist in the name of the corporation. Where land is transferred to the corporation, the annual notice for property taxes will be made out to the corporation instead of the farmer as an individual.

Advantages of a Corporation

- **Limited Liability** – Perhaps one of the most obvious advantages of the corporation is its limited liability. We often see "Ltd." after the name of the corporation which indicates a "limited corporation". Basically, this refers to the exposure of the corporation's assets to legal action. Any legal action taken by creditors could only be against the assets owned by the corporation. For the farmer who owns personal assets outside the corporation, this offers protection. However, where the farmer has given a personal guarantee on a loan to the corporation, the advantage of this limited liability is greatly reduced.
- **Income splitting** – The corporation may pay both the husband and wife a salary for services rendered, enabling the splitting of income. In this way, taxes are saved and both spouses can contribute to the Canada Pension Plan. As well, there will be more personal exemptions as both spouses will have income against which these may be claimed.
- **Permanence** – Unlike a natural person, the corporation can live forever. It would cease to exist only if it failed and its creditors had its affairs wound up or if it is struck off the register maintained by the Registrar of Companies because certain statutory requirements had not been met. The corporation can also cease to exist if the shareholders should decide to liquidate the corporation.
- **Ease of transferability** – The transfer of ownership in an incorporated farming business only requires that the farmer transfer the shares of the corporation. For an unincorporated business to be transferred, ownership of each individual asset would need to be changed. This aspect of a corporation also provides a great deal of flexibility in estate planning.
- **Tax-deferred rollover of property to a corporation** – As discussed earlier it is possible to transfer assets into a corporation without incurring an immediate tax burden. Instead, the tax which would otherwise arise may be deferred, either in whole or in part.

  As discussed earlier, it may also be advantageous to recognize unrealized capital gains on the transfer of property to a corporation.

  It is also possible to transfer the shares in a family farm corporation to the children without triggering any tax.
- **Flexibility of year end** – As with the sole proprietorship and partnership, the corporation may select a year end which best suits the operation.
- **Flexibility in tax planning** – The income tax rules which govern the taxation of income earned in a corporation are more complicated than those of other business organizations, but they do provide a great deal of flexibility in tax planning. Very briefly, here are some examples:
  - the ability to adjust salaries and dividends paid out to the shareholders
  - automatic averaging – because the corporation pays tax at one rate there is essentially, an automatic average tax rate:
  - greater use of certain employee benefit plans such as registered pension plans and group insurance plans;
  - dividend tax credit on dividends paid to shareholders;
  - the ability to lease land owned personally to a family farm corporation and still have the land qualify for the family farm rollover provision.

Disadvantages of a Corporation

- **Increased costs for start-up and yearly operation** – The corporation is a fairly complex organization and is, therefore, more costly to set up than other forms of business arrangements. As well, with extra accounting required for the operations, the yearly operating costs will be greater.
- **Small business rate restricted to active business income** – Any capital gains realized or investment income earned by a corporation is not eligible for the reduced small business rate. It will be taxed at a higher rate, which for 1988 was approximately 44%. Included in this rate, however, is a refundable tax of 16.67% which may be recovered upon payment of dividends.
- **Losses not offset against other income** – Any losses which are incurred in the corporation cannot be deducted from the income of its shareholders. Remember, the corporation is a separate legal person.
- **Withholding taxes on salaries** – Salaries which are paid to employees of the company must have the appropriate income taxes, Canada Pension Plan and Unemployment Insurance (in some cases) contributions deducted and forwarded to Revenue Canada. This creates additional accounting costs.
- **Splitting up the farm** – Although it is possible to transfer assets into a corporation on a rollover basis, it is very difficult to transfer assets out of a corporation on a tax deferred basis.
- A corporation does not qualify for the $500,000 capital gains exemption on the sale of corporate owned property.

Additional Comments on Farm Incorporation. Farmers have shown a significant amount of interest in farm corporations. With the tax provisions allowing the rollover of shares in a family farm corporation, this interest has increased. In connection with incorporating the farm, the following questions are often asked:

- **How big should my farm be before I benefit from incorporation?** In general, the farm should be earning income at a level where the tax advantages of incorporation become effective. At lower levels of farm income, there are other tools available to help reduce taxes, making incorporation uneconomical.
- **How much can I pay my spouse?** For a farm spouse who works for the company, any wage which is reasonable for the type of work being done would be acceptable. A guideline might be whatever you would pay someone else to do the same work.
- **Who runs the farm corporation?** The farm corporation is controlled by those who own the majority of voting shares. Significant decisions are usually made at an annual meeting or by the board of directors. Day-to-day decisions are made by the individual responsible for the normal farm operation. Despite the formality of the corporation, the farmer and spouse would normally control the board of directors and would be making the decisions as before. However, if a farmer brought in more shareholders, this could change.
- **Do shareholders have to be actively farming before they can rollover their shares in the corporation?** Under the extended rollover provision, only one member of the immediate family need be actively involved in running the farm. Other shareholders may work wherever they choose, and still be entitled to transfer their shares under the rollover provision.

The above are only some of the questions about incorporating which are frequently asked. However, it is not possible to go into greater detail in this publication. Owing to the complexity and consequences of various arrangements for farm businesses, seeking qualified professional guidance before any decision is made is recommended.

Estates

When the owner of a farm property dies, the tax consequences are greatly varied. As a result, there are no simple rules to planning a person's affairs for the event of death. However, some forethought and careful planning to minimize tax burdens will help achieve any estate planning goals as well as ease the financial burden on the family.

This chapter discusses some of the major considerations in establishing an estate plan.

Wills

Transferring assets by means of a will is known as bequeathing. The necessity and importance of preparing a will to direct the distribution of property in your estate cannot be stressed enough. Yet, in spite of its importance, many people die without having made a will, causing a great deal of unnecessary and expensive problems.

The farm property usually is the major asset of most farmers. By having a will, a farmer leaves instructions on how her/his property is to be distributed. The individuals selected as executors of the estate will collect and inventory the farmer's property, pay any debts and taxes, and distribute the property remaining as directed by the will. Without a will, there is no indication as to how the farmer's property is to be distributed. Having a plan through a will can help avoid excess taxes on the deemed disposition of assets at death, and will aid in distributing the deceased farmer's property to the chosen beneficiaries.

If a person dies without leaving a will, the estate will generally be divided based on the provisions of a provincial intestate succession act. An intestate succession act, basically, provides a will for that person and cannot take into consideration the needs of each particular family. As a result, some untoward results can arise. For example, in Alberta, when a person dies without a will (called dying intestate) and the estate has a net value of less than $40,000, the entire estate goes to the spouse. Where the net value of the estate is greater than $40,000, the surviving spouse receives $40,000 and the balance is divided as follows:

- If the person dies leaving a spouse and one child, one-half of the remainder goes to the spouse and one-half to the child.
- If the person dies leaving a spouse and more than one child, one third of the remainder goes to the spouse and the other two thirds is divided equally among the children.
- Where there are no children, the surviving spouse receives the entire estate.

If a person dies intestate and there is no surviving spouse or children, the estate shall go to the nearest kin of the deceased. When no heirs survive the deceased, the estate will generally go to the Crown.

As is evident from the above discussion, dying intestate will result in property being divided according to provincial laws. The final distribution of property in the estate may not bear any similarity to the wishes of the deceased.

Both husband and wife should sit down with a lawyer and each have a will drawn up, if only to avoid the administrative problems which arise when a person dies intestate. Once a will is made, it is easily altered to meet changing conditions and wishes as time goes on. Therefore it should be kept up to date.

Deemed Disposition

With the tax reform of 1971, the federal government abandoned its estate and gift tax legislation, and instead, brought in a tax on accrued gains of capital property which is gifted or bequeathed. Thus, a gift of capital property or property that passes to an heir on the death of a taxpayer is subject to a **deemed disposition.** A taxpayer is considered to have disposed of any capital assets (other than depreciable assets of a prescribed class) at the time of gifting or immediately prior to death, and to have received

proceeds equal to the **fair market value** of those assets. Therefore, on any such property, the fair market value must be determined and any capital gain or loss resulting from this deemed sale must be declared on the deceased taxpayer's final income tax return. The recipient of the capital property that is gifted or bequeathed is deemed to have purchased the property for the same amount for which the property was deemed to have been sold.

Where property qualifies under any of the rollover provisions discussed earlier, the deemed disposition rules do not apply. Where a farmer is gifting or bequeathing property to heirs, it is important to ensure that the requirements of the rollover rules to defer the taxes on the transfer of the property are met. As well, the above rules do not apply on the transfer of property to a spouse, or to bequests of cash.

Depreciable Assets. The deemed proceeds on depreciable assets of a prescribed class (i.e., declining balance method) is an amount half-way between fair market value of the assets in the class and the undepreciated capital cost of the class. The following example shows how this is calculated:

EXAMPLE

Capital Cost		$8,000
Fair Market Value		6,800
Undepreciated Capital Cost		4,900
Deemed Proceeds		
$\frac{UCC + FMV}{2}$	= $\frac{\$4,900 + 6,800}{2}$ = $5,850	
Recaptured Capital Cost Allowance		
Deemed Proceeds – UCC	= $5,850 – $ 4,900	
	=	$ 950

In the above example, the taxpayer will be deemed to have received proceeds of $5,850. The recaptured capital cost allowance for the assets in the class ($950) will be included in the taxpayer's income for the year of death. The deemed proceeds in the example are less than the capital cost, so there is no capital gain.

Where a capital gain occurs, three-quarters (two-thirds in 1988 and 1989) would, subject to the capital gains exemption, be added to the deceased's income and taxed at normal rates.

Where a farmer has assets on the straight-line method of capital cost allowance, the assets are transferred at the fair market value without the incidence of recapture. The beneficiary of the asset must then claim capital cost allowance on the declining balance method. As well, the beneficiary is deemed to have acquired the property at a cost equal to the deemed proceeds of the deceased.

Again, for depreciable property being transferred to spouses or children, the rollover rules may apply if the farmer so wishes. Under these provisions, declining balance assets can be transferred at their undepreciated capital cost (book value).

It may be advantageous to exclude certain assets from the rollover provisions in order to utilize any remaining capital gain exemption.

Actual Dispositions

The deemed proceeds of disposition established at death may vary from those amounts subsequently realized on an actual subsequent disposal. In this situation, the Act permits an adjustment for losses incurred within twelve months after death. If the estate disposes of capital property within twelve months and incurs either a capital loss or terminal loss, the deceased's income is recalculated taking into consideration this loss with any resulting tax saving treated as tax prepayment for the estate. In effect, the loss has been carried back to offset any gains accrued at the time of death.

An exception to the capital loss carry forward provisions allows any unabsorbed capital losses in the year the taxpayer dies to be applied against any income for the year of death or for the immediately preceding year.

Rights Or Things

There is also a deemed realization on assets of an income nature, such as grain, livestock and

other farm products which are on hand at the date of death. These assets do not qualify for the farm rollover provisions and therefore must be included on the final income tax return. They are referred to as the deceased's "rights or things".

There are few options available for filing income tax returns which include the value of these rights or things:

- The value of rights or things may be included in the return filed for the entire estate.
- A separate return may be filed for the rights or things on hand at the time of death as if it were for a separate individual entitled to all personal exemptions.
- The rights or things may be transferred to the beneficiaries at the deceased's cost base immediately before death. The beneficiaries become responsible for declaring the income received from their realization or the income earned on such realization.

Further information is available from Revenue Canada in a booklet: Supplementary Guide T1 Income Tax Returns for Deceased Persons.

Trusts

It is possible for a farmer to leave the farming business in a trust created by the will. When a farmer dies leaving a spouse and children, the trust could operate so that the spouse could receive income from the farming business for life. Then, upon the spouse's death, the farm property would be divided among the surviving children as indicated by the will. In some cases, this may be a practical and desirable approach to estate planning.

The Income Tax Act provides special rules for the establishment and use of trusts, and basically, allows the spousal rollover and the farm rollover to be combined to defer tax. To qualify, the trust for the spouse must first meet all of the rules necessary for the spouse rollover. Either a trust arising at death or a trust established while the farmer is alive will qualify. The requirements of the rollover provisions, when using a spouse trust are as follows:

Canadian Property. As discussed earlier, the property must be land or depreciable property which is situated in Canada, or an interest in a family farm partnership, or a share in a family farm corporation.

Qualified Spousal Trust[1] The property must vest indefeasibly in a "qualified spousal trust" within 36 months from the date of death (whether the trust arises on the death of the individual or is established during the individual's lifetime). If the trust is a "non-qualified spousal trust"[2], the rollovers are lost and the property will be deemed to have been disposed of as discussed above. It is important to get professional help when setting up a spousal trust to avoid disqualifying it for the rollover.

Vesting on Death of the Spouse. When the spouse for whom the trust was set up dies, the property must be transferred or distributed to a child or children of the individual. The child or children must be resident in Canada at the time of the spouse's death.

The property must be used in the business of farming by someone. However, there is no specific requirement that the individual, spouse, or child be actively farming it when it is rolled into the trust or when the property is rolled out of the trust to the children.

If the above rules are met, a tax-deferred rollover is available for property transferred to a spousal trust and then to a child.

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[1] A "Qualified Spousal Trust" is one in which the spouse alone receives the income or capital from the trust while alive.

[2] A "Non-qualified Spousal Trust" is one where the spouse and others may receive the income or capital or the continuation of the trust is dependent on some future action of the spouse, i.e.,

Life Estates

If a farmer is in a position to retire, and does not need to sell the property to provide for retirement, the creation of a life estate may be an appropriate estate plan. To set up this arrangement, a farmer would "partition" the property retaining a life interest, and transfer the remainderman interest to a child or children. (A life interest is a legal term meaning the right to the use and enjoyment of the property and any income earned by the property. A remainderman interest is a legal term meaning the right to title and the right to the life interest on death of the present holder of the life interest.) The parents will have a right to the income from the property as long as they live. Upon the death of the parents, the life estate title merges into the remainderman title.

Revenue Canada's present position is that this procedure will qualify for the farm rollovers discussed previously, providing the other requirements of the provisions are met and that both parties agree in writing that there is a transfer of land subject to the particular rollover provision. The land would roll over at the farmer's adjusted cost base with no adjustment for the life interest. On the death of the life tenants, there would not be a deemed disposition of the life interest.

Some of the benefits of using this approach are as follows:

- subsequent changes in tax laws will not affect the rollover;
- where a farmer wishes to retire but does not have any children interested in farming, this rollover can be completed while still in the business of farming;
- the child who has the remainderman interest can use the land as if it was leased with the knowledge that eventually full title will be acquired;
- as the land will not go into the estate, probate fees would be reduced.

As this area is quite complex, it is strongly recommended that professional advice be sought.

Other Considerations

Forward Averaged Amounts. Where an individual has elected to forward average in a prior year, there are two alternatives for the year of death. The individual can elect to include a portion of the forward averaged income in income for the year of death. To the extent that all of the forward averaged income is not included in the final return, one-third of this difference will be included in each of the immediately preceding three years. As discussed earlier a credit against taxes will be received in the year of death for any tax paid on the forward averaged income. This would also apply to each of the preceding three years.

Reserves in the Year of Death. A capital gain reserve in respect of the gain included in a person's income is not available in the year of death. The entire taxable capital gain that is remaining must be included in the individual's income for the year of death, even though it will not be received until a future date. This applies except where a spouse, or a spouse trust set up on death, is the beneficiary.

Restricted Farm Loss in Year of Death. An unabsorbed restricted farm loss remaining on death will not be allowed to offset income of the farm earned by the estate. For tax purposes, the estate is considered a separate individual and, therefore, it cannot take over the restricted farm loss of the deceased. If the farm is to be disposed of, a portion of the restricted farm loss (representing any interest or property taxes included in the loss) may be applied to reduce any capital gain realized on this disposition.

Minimum Tax in Year of Death. Effective for 1987 and subsequent years the minimum tax will not apply in the year of death.

Farm Quotas

Prior to 1972 the sale or purchase of a quota had no effect on a farmer's tax position. Subsequent to that date the rules regarding amortization (i.e., depreciation) of quotas purchased and the inclusion of a portion of the sale proceeds in income has become quite complex. A summary of the existing rules along with the rules to be in effect in 1989 are detailed below:

Amortization

One-half of the purchase cost of quota is recorded in the Cumulative Eligible Capital (C.E.C) account. Regardless of whether the farmer calculates tax on the cash or accrual method, the purchase cost is the amount paid plus any amount owing or outstanding on account of the quota. At year end the balance of this account, or pool, is amortized on the declining balance basis at a maximum rate of 10% per year. (See page 10 for a discussion of assets depreciated on a declining balance basis.) In other words, 10% of the value of the C.E.C. account is recorded as an expense similar to capital cost allowance. The balance in the C.E.C. account is similar to the undepreciated capital cost of a depreciable asset.

Tax Reform. *Effective for fiscal periods commencing after December 31, 1987 (after June 30, 1988 for corporations), taxpayers are allowed a maximum amortization rate of 7%. As well, for quota purchased after this effective date, three-quarters rather than one-half of the purchased cost of the quota is included in the C.E.C. pool. In effect, the new rules will reduce the amortization rate but increase the value of the C.E.C. pool that is being amortized.*

In providing a transition from 1987 to 1988, the rules require that the balance of the C.E.C. pool on hand at the end of 1987 be increased by 50%. This increase is to take place on the effective date of the new rules (i.e., the beginning of fiscal periods commencing after 1987, for individuals).

Sale of Farm Quota

When a farmer sells quota, one-half of the proceeds are deducted from the balance in the C.E.C. pool. Any balance remaining is then amortized at 10% per year. On the other hand, where the portion of proceeds credited to the pool exceeds the balance remaining in the pool, the excess is included in income.

Where quota purchased prior to January 1, 1972 and used in a farming business is sold, the actual proceeds are reduced by the greater of i) the cost of this quota and ii) the fair market value of this quota at December 31, 1971. One-half of the deemed proceeds are then credited to the C.E.C. account.

Tax Reform. *Effective for fiscal periods commencing after 1987 (after June 30, 1988 for corporations), the portion of the proceeds to be credited to the C.E.C. pool will increase from one-half to three-quarters. Any balance remaining is to be written off at 7% per year. Alternatively, where the proceeds credited to the pool exceed the balance remaining, the excess is taxed as follows: the portion of the negative balance that represents a recapture of amounts claimed in prior years is included in income. The remainder of the negative balance is a taxable capital gain and eligible for the capital gains exemption.*

An example of this case follows:

A farmer purchased a quota for $20,000 in 1988, claimed the maximum deduction in 1988 and 1989 and disposed of the quota in 1990 for $40,000. The continuity of the farmer's C.E.C. pool would be as follows:

Year			C.E.C. Balance
1988	addition	$20,000 x 3/4 = $ 15,000	$ 15,000
1988	claim	$15,000 x 7% = $ (1,050)	$ 13,950
1989	claim	$13,950 x 7% = $ (980)	$ 12,970
1990	proceeds	$40,000 x 3/4 = $(30,000)	$ (17,030)

The farmer would be required to include $2,030 in his income in 1990 which represents a recapture of the amounts claimed in prior years ($1,050 + $980). The remaining $15,000 of the negative balance ($17,030 - $2,030) would be a taxable capital gain and eligible for the capital gains exemption.

It is apparent that if you anticipate future increases in the value of quota, it would be beneficial to hold the quota personally (i.e., not in a corporation) and ensure that any gains on sale will therefore qualify for the capital gains exemption.

Prior to June 17, 1987 the proceeds of disposition of farm quota was not required to be recognized until such time that the purchaser was required to pay the purchase price. The new legislation requires that for dispositions of eligible capital property after June 17, 1987, the proceeds must be credited to the pool in the year of disposition. This effectively eliminates the possibility of claiming a reserve for proceeds not due. However, with the introduction of the new rules that permit gains on quota to be treated as capital, the benefits of claiming a reserve are not as significant as in the past.

Unusual and Miscellaneous Sources Of Income

Subsidies

Government grants or subsidies will be either included in income in the year they are received (e.g., Special Canadian Grains Program payments), or used to reduce the costs of assets purchased (e.g., Investment Tax Credits). The following assistance programs are the most common in agriculture.

Gasoline Tax Rebates. The federal and provincial tax rebates on farm fuel used in the farming operation can be included as income or deducted from expenses. Under the Alberta Farm Fuel Allowance Program the most common reporting procedure is to record the net amount paid as an expense since the allowance is automatically deducted on each purchase (Total Cost – Allowance = Net Paid).

On the other hand, one must apply for the Federal Excise Tax Refund on farm fuels. When received, this refund is normally included as business income or used to reduce the cost of fuel for the year.

Destruction of Livestock. Compensation for the destruction of livestock must be included in income either in the year of destruction or in the immediately following taxation year. Examples of such programs include the Livestock Disaster Predator Indemnity Program and the Brucellosis Compensation Program.

PFRA Water Development Project. The cost of specific construction items related to water storage, irrigation projects, and farm wells are either deductible in the year incurred or must be capitalized. Grants under this program, therefore, must be allocated between these two types of expense.

Capitalized costs normally consist of the water distribution system including the cost and installation of the pump casing, piping and trenching. On the other hand, the cost of drilling a well may be claimed as an expense. When completing your tax return, handle the grants as outlined below:

- If the grant is based upon deductible expenses the money received has to either be included as income or deducted from the expense claimed for the project.
- If the grant is based upon a capitalized expense the money received is not taxable but the undepreciated capital cost (UCC) of the asset class affected must be reduced by the grant received before capital cost allowance (depreciation) is taken.
- **Note**: **The Assistance Available for Alberta Farmers** publication (Agdex 871) outlines these and other financial assistance programs.

Insurance Proceeds

Under insurance policies and programs, farmers may receive many forms of compensation with different tax rules applying. The following are the most common insurance claims.

Life Insurance. Since life insurance premiums are normally not classified as deductible expenses, the proceeds from life insurance policies are not taxable. An exception to this rule occurs if your lender provides a letter indicating that the insurance is a prerequisite of the loan and that the policy is assigned to the lender. The premiums are then deductible as a business expense with the proceeds remaining nontaxable. This type of policy is usually reducing term insurance where the amount of insurance coverage decreases by the amount paid on the loan principal.

Fire, Casualty and Theft. Farmers may deduct the premiums under these policies as business expenses. When insurance money is received to compensate for loss or damage to inventory, the amount received is treated as taxable income. Hail and crop insurance and livestock insurance are examples of this type of policy coverage.

Farmers who spend insurance proceeds received for damages to depreciable assets

(buildings and machinery) will have an offsetting expense (repairs) for the income received through insurance.

If depreciable property is damaged and the insurance proceeds are not used in repairing the damage, the proceeds will be treated as proceeds of disposition rather than taxable income. Similarly, if the damage was so extensive that the property could not be repaired, a deemed disposition has occurred.

Under a deemed disposition the same tax rules apply as if the property had been sold. Potential recaptured capital cost allowance (depreciation) and capital gains could be triggered unless a replacement asset is acquired with the insurance proceeds. If the cost of the replacement asset is equal to or greater than the insurance proceeds, the taxable income triggered could be minimal or nil. For an involuntary disposition, the replacement property must be acquired before the end of the second taxation year following the year the asset was destroyed to qualify under the replacement property rules.

Sale of Farmland Including the Crop

Where farmland is sold including a standing crop and a value is placed on the crop in the agreement, the value of the crop is reported as income by the vendor. This amount then becomes an expense to the purchaser. Where no value is specified for the standing crop it is neither income to the vendor nor an expense to the buyer. Instead, the value of the crop is included in the land value and would be subject to capital gain in the hands of the vendor. The buyer would take over the land with an equal increase in the cost base.

Patronage Dividends

All patronage dividends with the exception of those for personal goods or services are taxable in the hands of the farmer when received. Where the payment has been made in the form of a share, or certificate of indebtedness, the patronage dividend is interpreted as received by the customer.

For example, farm cooperatives often declare dividends but the farmer receives only partial cash consideration. For income tax purposes, however, a farmer is required to pay tax on the cash received plus that portion of the dividend retained by the cooperative which is converted to equity. Enter this amount on the schedule of Farm Income and Expenses. These dividends are not eligible for the dividend tax credit. If a dividend of over $100 is declared, a 15% withholding tax is levied and forwarded by the cooperative to Revenue Canada and credited to the farmer's account. When filing your tax return, do not forget to include this credit on the line entitled "Amounts Paid by Instalments". Remember also that dividends received for personal items, such as groceries are not to be recorded as income for tax purposes, however, the tax witheld is still treated as an instalment.

Oil and Gas Exploration

Payments received by an owner of farmland for leases of surface rights often require a lump sum to be paid in the first year. This payment is for such things as damages to the land, inconvenience, severance and the first year's rent.

The second and subsequent years require an annual rental payment including a yearly allowance for inconvenience and severance. The lump sum received in the first year less the amount equal to the subsequent annual payment is considered a capital receipt. An exception would be where the first year's payment specifies an amount payable for damage to a crop. This compensation is considered income.

To illustrate the proper procedure in reporting the income received, the following example is provided:

> Mr. Ford purchased a section of bare land in 1974 for $300 per acre for an adjusted cost base (ACB) per quarter of $48,000 (160 acres x $300/acre). In 1984, an oil well was drilled on the NW quarter with Mr. Ford receiving $10,000 from the oil company. The $10,000 payment consisted of a $2,500 annual rent and $7,500

compensation for damages to the property. On his tax return Mr. Ford would include the $2,500 as income, but not the $7,500 representing damages.

In respect to the damages (capital receipt) the payment can either be treated as a capital gain or the proceeds can be applied against the adjusted cost base of the land affected. The proper tax schedule in which to report this payment in is Schedule 3 "Summary of Disposition of Capital Property".

When claiming the receipt as a capital gain only three-quarters (two-thirds in 1988 and 1989) of the payment is taxable income. If the election is made to **reduce** the ACB of the land affected, the compensation **cannot exceed 20 per cent** of the ACB value. If the compensation exceeds this 20% allowance, the **entire amount** must be reported as a capital gain.

In Mr. Ford's case either option is available as the $7,500 payment for damages is less than 20% of the ACB of the property affected ($48,000 x 20% = $9,600). If Mr. Ford elects to apply the $7,500 receipt to the ACB of the NW quarter, the result will reduce the ACB of the quarter to $40,500. ($48,000 – $7,500). As can be seen, this option is only a means of postponing the tax payable on the damage payment until the NW quarter is ultimately sold.

In some circumstances it may be advantageous for the farmer to incur a capital gain by not applying the sale proceeds against the ACB of the remaining land. This would be good tax planning where insufficient income has been earned to claim personal credits, capital cost allowance (depreciation), utilize available investment tax credits or the $500,000 capital gain exemption.

Part Dispositions

The granting of an easement, a public right-of-way or where property is expropriated for use as a right of way, constitutes a partial disposition and may result in capital gains being triggered. (See Interpretation Bulletin IT-264R.) The Income Tax Act allows for the same reporting procedure as explained under the Oil and Gas Exploration section for any payments resulting in a capital gain.

Income From Farm Woodlots, Tree Farms, Sand and Gravel Sales

Where a farmer sells logs, lumber, firewood or Christmas trees, and the proceeds are minor in relation to the farming operation, the proceeds are considered income from farming. Under these circumstances the cost of replanting trees and bushes is deductible in computing farm income.

Small amounts of sand, gravel, stone or soil sold from your farm are included as farm income also. The first $100 that is received from such a sale each year need not be reported as income provided no depletion is claimed.

If the sale of trees or gravel is an ongoing event, then a depletion allowance can be claimed. This allowance is based on a per unit basis sold, determined by the following procedure:

a) capital cost of the land with the product included;

b) value of the land with the product (trees, gravel) removed;

c) subtract these two values (a – b) to arrive at the residual value for the product;

d) this residual value is then divided by the estimated quantity of the units to be sold;

e) the market value received for each unit is then reduced by the residual value calculated in (d) above.

When the sale transaction is a single transaction not determined by a per unit basis, such as a lump sum payment, the payment is normally considered to be capital. No depletion is allowed in this case. The adjusted cost base of the land could be reduced by an amount equal to the proceeds of such a sale. The adjusted cost base can be reduced to **nil** and a capital gain is triggered, only if the payment is in excess of the adjusted cost base.

Transfer or Exchange of Products

If a farmer transfers farm products in exchange for goods or services, the fair market value of the farm product is to be included in income. If the good or service received relates to the farm business, then the fair market value of these goods or services will be treated as an expense or as capital, depending on their nature.

For example, if a farmer exchanged grain for a swather, the value of the grain is recorded as income and the value of the swather would be a capital addition subject to capital cost allowance. If the grain were exchanged for a motorhome then the value of the grain would be included in income with no offsetting deduction for the motorhome, since it is not a business item.

If the exchange occurs between two parties dealing at arm's length (e.g., not a family member) then the two values (i.e., the grain and swather) will be considered by Revenue Canada to be equal.

If a farmer gifts saleable farm produce, e.g., grain or cattle to a family member, the fair market value of the produce is included in the farmer's income. The recipient of the gift is entitled to deduct the fair market value of the gift. Any future income earned by this gift is taxable in the recipient's hands; the attribution rules do not apply to business income.

If the farmer did not gift, but instead, sold farm produce to a family member at an amount less than fair market value, the rules in the Income Tax Act prevent equitable tax treatment. In effect the farmer is required to include the fair market value of the produce in income, but the recipient can only deduct the amount paid for the produce.

If the farmer requires, for example, $1,000 payment for $5,000 worth of produce sold to a family member he is better off either:

- gifting the produce and receiving a $1,000 gift of cash in return; or
- selling the produce at fair market value ($5,000) and gifting $4,000 cash to the purchaser in order to assist in the payment for the produce.

It is not advisable to forgive a portion of the debt owing (in this case $4,000) as undesirable consequences may arise as a result of the Income Tax rules relating to forgiveness of debt.

The transfer of property (land, buildings, quota, etc.) are discussed in other sections of this book.

Mineral Rights and Tax Implications

Farmers and other individuals who own gas and oil mineral rights could encounter serious income tax liabilities when the ownership of these rights changes through a transfer by sale, gift or bequest.

As a result of the introduction of the taxation of property dispositions in 1972 including the gifting or bequeathing of property, all transactions concerning resource properties now come into the computation of income and not capital gain.

Since December 11, 1979, the disposition and acquisition of Canadian resource properties have been administered through Canadian oil and gas property expense accounts. The Canadian oil and gas property expense account functions in a similar way to capital cost allowance schedules for farm buildings and machinery. If the account, at the end of a given year, has a positive balance, (i.e., purchases exceed dispositions) a deduction of 10 per cent of the balance may be claimed in calculating the income for the year. If the account is negative (i.e., dispositions exceed purchases), and the taxpayer does not have a balance in the cumulative Canadian development expense pool, the negative amount is added to the income of the taxpayer for that year.

Rollovers of Resource Properties

The rollover provisions of the Income Tax Act can apply to transfers of resource properties if the taxpayer or the taxpayer's executor so elects. The rollover provisions will only apply to the testamentary transfer to a spouse or spousal trust, or to a corporation or partnership. The transfer may take place at any elected amount up to the fair market value of the resource property.

In the case of a testamentary transfer to a spouse or spousal trust, it must be shown within thirty-six months after the date of death that title will vest indefeasibly.

The taxation benefit this type of transaction permits is for one spouse to ensure the other spouse receives any revenue from the resource property throughout the surviving spouse's lifetime. Upon the death of the surviving spouse, the resource properties are likely to be transferred to children or other taxpayers, thereby triggering the taxation of the resource properties. Therefore, the use of a testamentary transfer to a spouse or spousal trust provides the advantage of tax deferral but not tax reduction.

For transfers of resource properties to children and other taxpayers, the transfer must take place at fair market value. The full amount of deemed proceeds as a result of the transfer must be brought into the income of the transferor in the year the transfer takes place.

Where there is a deemed disposition of a resource property on death, and the beneficiary is an individual other than a spouse or spousal trust, the proceeds are brought into income for the final year of the deceased taxpayer. The executor of the estate may elect to pay tax in up to ten equal annual instalments, commencing with the year of the final return, provided that acceptable security has been furnished to the Minister of National Revenue. Interest at the prescribed rate per annum must also be paid each year as calculated from the filing due date of the tax return for the year of death. Note this interest expense is not deductible for tax purposes by the estate.

The following is an example of a deemed disposition of a mineral right being transferred to a child.

Assume:

Mr. Farmer wishes to transfer his mineral rights valued at $100,000 to his child. The mineral right was bequeathed to Mr. Farmer in 1965 and no proceeds are actually being received by him in the transfer.

Canadian Oil and Gas Operating Expense	**Parent**	**Child**
Opening Balance	$ 0	$ 0
PLUS: Current year expense account to purchase Mineral Rights	$ 0	$100,000
LESS: Current year Resource Property Dispositions	$(100,000)	$ 0
Equals: Year end Oil and Gas Property Expense	$(100,000)	$100,000
Taxable Income:	$ 100,000	
Allowable deduction: 10%		$10,000

The above example illustrates that Mr. Farmer will be deemed to have received $100,000 for his resource property while his son will be deemed to have acquired the mineral right for $100,000 and be allowed to deduct a $10,000 deduction against other income. These rules are very similar to the disposition of machinery where the recaptured capital cost allowance (RCCA) can be triggered resulting in taxable income to the seller and depreciation allowance to the purchaser. The important distinction between the two, however, is that farm machinery qualifies for the family farm rollover provision and can be "rolled over" to a child at the undepreciated capital cost balance (UCC) resulting in no taxable income.

A mineral right, however, does not qualify for the family farm rollover provision and thus is deemed sold at fair market value.

Partnerships and Corporate Arrangements

Resource properties may be rolled into a partnership or corporation on a tax deferred basis. The owner of the mineral right will in exchange receive a partnership interest or corporate shares that reflect the value of the mineral right transferred. Any increase in value of the mineral right can then be divided among other members of the partnership or shareholders. This type of value freeze is common among family members when the owner rolls the mineral right to a corporation and receives preferred shares equal to the fair market value of the property. Spouses and children then subscribe for common shares that will represent the future growth in value of the resource property.

The current growth is frozen in the preferred shares and that value can be realized upon redemption of the shares. It is recommended that some current value preferred shares be redeemed before death to avoid capital gains on death if the capital gains exemption will not be available (i.e., previously used up). The redemption of such shares receives dividend treatment to the shareholder.

Another advantage of holding mineral rights through a corporation is that upon death of the original owner the estate will be transferring shares and not the actual mineral right. Under the Income Tax Act, shares of such corporations will qualify for the $100,000 capital gains exemption thus deferring the tax liability for the deceased taxpayer. The recipient of the corporation (via transfer of shares) will now own the company that owns the mineral right with the potential to not trigger any tax liability throughout the transaction. If the capital gain on the transfer of the shares will exceed $100,000, consideration should be given to rolling over shares to a spouse and upon their death an additional $100,000 of capital gain will be sheltered. It is important to understand that if the resource property is ever sold by the corporation then the applicable corporate rate is applied to the income received. When the retained earnings are then distributed by way of dividends the shareholders will also be faced with personal tax.

The underlying feature of a transfer to a partnership or corporation is that while these

vehicles permit a rollover, the taxation of the property will occur when the arrangement is disassembled and the mineral right actually disposed of. The taxation benefit of such arrangements is still mainly limited to the deferral of tax and income splitting through a value freeze.

Valuation of Mineral Rights

Establishing the fair market value of resource properties is critical. In terms of taxation, the higher the fair market value, the greater the potential tax liability becomes. From the point of view of tax planning, the value of mineral rights is extremely important and depending upon the circumstances, can influence when transfers are made.

The issue of determining the fair market value of resource properties is complex. It is important to stress that mineral rights and their values are subject to market forces, just as other property values are. Factors such as petroleum markets, government programs and proximity to producing fields, as well as other factors, all contribute to the valuation of a mineral right at any given time.

The market value of a resource property is generally determined by estimating the future cash flow of the property and adjusting it for risk.

The determination of market value is best done by a qualified appraiser of mineral rights. The cost of an appraisal is usually established on a fee for service basis, rather than a percentage of the value of the resource property.

Revenue Canada does not require a formal appraisal of the valuation of mineral rights upon transfer. However, if the value of the mineral right transfer is not acceptable to Revenue Canada, the onus is on the taxpayer to justify the value chosen.

Although the cost of an appraisal may seem to be an unnecessary expense, the appraised value might incur less taxation than an unqualified estimate.

Summary

It is apparent that individuals who own mineral rights, upon which there is commercial production, may be faced with substantial income tax liabilities upon the disposition or deemed disposition of these properties. Individual cases should be examined in order that appropriate tax and estate planning can be made to minimize the potential tax burden and to ensure the availability of funds to cover the expected liability.

Conclusion

This publication has discussed a number of tax strategies available to the farm manager. Although the strategies presented are by no means exhaustive, they illustrate the importance of tax planning to the farm business. Such strategies are important in the short term, and may have long-term implications as well.

It is important to keep in mind that the objective of tax planning is to **maximize income after tax.**

Up-to-date financial records are necessary so that planning can be done before the year end. The individual with the greatest knowledge of the farm business is the farm manager. This individual must have an understanding of the implications of various tax rules in order to ask a tax advisor the appropriate questions. In this way, the tax advisor can best assist the farmer in evaluating various alternatives. The farm manager can then decide which alternatives are best suited for guiding the farm business towards achieving both economic and personal goals.

APPENDIX

TAX RATE SCHEDULE, 1988

Taxable Income	Tax %
Up to $27,500	17
$27,501 to $55,000	26
$55,001 and over	29

Personal Tax Credits

Basic personal credit	$1,020
Married credit	850
Equivalent-to-married credit for a dependant who is under age 18 at any time in the year, the taxpayer's parent or grand – parent or an infirm person related to the taxpayer	850
Dependants under age 18 at any time in year:	
– for each of the first two such dependants	65
– for each additional such dependant	130
Infirm dependants age 18 or over at any time in the year	250
Age credit	550
Disability credits	550

The income threshold above which the credits are reduced would be $500 with respect to a spouse or dependant in respect of whom the married or the equivalent-to-married credit is claimed and $2,500 with respect to any other dependant.

Individuals: Provincial Rates

In addition to the tax under the Federal Act, as above, an individual who resides in or has income earned in any of the provinces is also subject to provincial income tax. Except for Quebec, which collects its own tax on separate income tax returns, each province imposes a tax which is expressed as a percentage of the federal tax. This tax is collected for the province by the Federal Government on a joint tax return. Following are the rates for income tax and surtax imposed by the "agreeing provinces" for 1988.

Nfld.	60.0%	Man.	54.0%
N.S.	56.5	Sask.	50.0
P.E.I.	56.0	Alta.	46.5
N.B.	60.0	B.C.	51.5
Ont.	51.0	N.W.T.	43.0
Y.T.	45.0		

Surtaxes

Ont.	10% of Provincial tax over $10,000
Man.	24% of tax on net income over $30,000; 2% flax tax on net income.
Sask.	12% of Provincial tax over $4,000; 2% flat tax on net income
Alta.	8% of provincial tax payable over $3,500; 0.5% flat tax on taxable income earned in Alberta
P.E.I.	5% surtax on provincial tax in excess of $12,500

Quebec Tax Rates

Taxpayers who reside in Quebec are subject to different rates than those outlined above.